UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, *et al.*, Defendants.	Adv. Pro. No. 10-05287 (BRL) Case No. 1:11-cv-03605-JSR

REPLY MEMORANDUM OF LAW OF THE SECURITIES INVESTOR PROTECTION CORPORATION REGARDING CALCULATION OF FICTITIOUS PROFITS

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Pursuant to this Court's order of September 28, 2011, the Securities Investor Protection Corporation ("SIPC") submits this memorandum of law in reply to the Defendants' Memorandum of Law Regarding Determination of "For Value" and Net Equity Decision [Docket No. 62] ("Def. Mem."). All capitalized terms used, but not defined, herein shall have the meaning attributed to them in the Memorandum of Law of the Securities Investor Protection Corporation Regarding Calculation of Fictitious Profits [Docket No. 61] ("SIPC Mem").

SUMMARY OF THE ARGUMENT

Defendants, in their Memorandum, rely upon a novel method that has no precedent or support for calculating "value" under section 548(c) of the Bankruptcy Code ("section 548(c)"). Despite the significant amount of Ponzi scheme case law – all of which holds that fictitious profits are determined by taking the total amount received by the customer and subtracting the amount of his actual investment – Defendants contend that they are entitled to keep every penny of fictitious profit – that is, other people's stolen money – Madoff invented and bestowed on them, up to the two years prior to the filing date.

This assertion lacks legal authority. It is incongruent with the plain language of the Bankruptcy Code and with the purposes of SIPA. It fails to preserve the priority status of customers under SIPA who have yet to recapture their principal, and allows the Defendants to retain the millions of dollars of other people's stolen money that Madoff chose to give them while the BLMIS victims who withdrew less than they invested receive mere pennies on the dollar.

Despite Defendants' arguments to the contrary, there is no time limitation on the determination of "value" under section 548(c). The Uniform Commercial Code does not provide that fictitious profits shown on account statements are enforceable obligations and thus constitute

"value" under section 548(c). Even if, however, Defendants had an enforceable claim against the Debtor, such a claim would not be a priority customer claim, but would at best be a general creditor claim that could not be satisfied with customer property.

ARGUMENT

I. DEFENDANTS CONFLATE THE TERMS "TRANSFER" AND "VALUE": "TRANSFERS" ARE LIMITED TO THE TWO YEAR LOOK BACK, BUT "VALUE" HAS NO SUCH TIME LIMITATION

As support for their novel argument that Defendants are entitled to retain fictitious profits prior to the two year look back period, Defendants conflate the terms "transfer" and "value." *See* Def. Mem. at 2-6. Section 548(a)(1) states: "The trustee may avoid any transfer. . . that was made . . . within 2 years before the date of filing the petition." Section 548(c), however, provides a defense for fraudulent transferees who "take[] for value and in good faith," and does not contain a time limitation on "value." Further, Defendants have not identified any case in which a time limitation was imposed on "value." SIPC, on the other hand, has identified a number of cases which look beyond two years to determine whether "value" was given in exchange for a transfer made *within* the two year period. *See, e.g, Perkins v. Haines,* __ F.3d __, 2011 WL 5103951 (11th Cir. Oct 27, 2011) (holding that in a Ponzi scheme, only the amount invested with a debtor constitutes "value," even if the transfers were made up to nine years prior to the petition date of the bankruptcy proceeding);[1] *Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996) (looking to the twelve year history of investments).

[1] A statement of facts is available in the Memorandum in Support of Trustee's Motion for Partial Summary Judgment, *In re International Management Associates, LLC*, Case No. 09-00601-pwb, (Bankr. N.D. Ga. Apr. 1, 2009), Docket No. 7.

See also SIPC Mem. at 5-6. Accordingly, Defendants have no basis for limiting the determination of "value" to the two years prior to the liquidation of BLMIS.

Defendants further argue that because a customer could withdraw the fictitious profits in his account two years plus one day prior to the liquidation, Defendants should be able to retain fictitious sums received by them two years plus one day prior to the liquidation. *See* Def. Mem. at 3. This argument has no basis in law or fact. In drafting section 548(a)(1), Congress specifically set forth the bounds of fraudulent transfer law. Similar to a statute of limitations period, this provision provides that if a *transfer* from the Debtor is made more than two years prior to a liquidation, it cannot be avoided under section 548(a)(1). However, that is a different question from whether the amounts in the account during that two year period are fictitious or not.

II. THE ACCOUNT BALANCES ARE NOT ENFORCEABLE OBLIGATIONS AND, AS SUCH, CANNOT CONSTITUTE "VALUE"

Defendants briefly state, without explanation, that Article 8 of the New York Uniform Commercial Code ("NYUCC") governs whether "value" was provided in exchange for the receipt of transfers by Defendants. *See* Def. Mem. at 3. Presumably, Defendants contend that under the NYUCC, the account statements by BLMIS create an enforceable obligation.[2] The plain language of the NYUCC, however, contradicts Defendants' assertions.

Notably, the Official Comment to the NYUCC itself, expressly citing SIPA as an example, specifies that SIPA overrides the NYUCC if the entity's affairs are being administered in an insolvency proceeding. *See* McKinney's UCC § 8-503, Official Comment 1 (2009)

[2] As stated on pages 4-5 of the SIPC Memorandum, a claim must be enforceable for it to constitute value under section 548(c). *See, e.g., Official Comm. of Unsecured Creditors v. Whalen (In re Enron Corp.),* 357 B.R. 32, 48-49 (Bankr. S.D.N.Y. 2006).

("applicable insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ….").

Even assuming, *arguendo*, that it governed the property rights of Defendants, the NYUCC does not provide Defendants with an enforceable claim against the Debtor for the value on their account statements. Indeed, NYUCC section 8-503(a)-(b) limits the Defendants to a "property interest consisting of a pro-rata claim to the fungible pool of underlying securities held by the intermediary." *See* James S. Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision*, 31 Idaho L. Rev. 689, 692 (1995). Even if this provision applied, which it does not, Defendants would have a property interest only in their pro rata share of the securities held by BLMIS, *not* in the fictitious profits on their account statements.

The remainder of section 8-503 of the NYUCC provides that a property interest may be enforced against a broker only by exercising rights available under sections 8-505 through 8-508. *See* NYUCC § 8-503(c). None of the enumerated rights apply here, relating, for example, to duties as remote as the pass through of dividends (section 8-505), the exercise of voting rights (section 8-506), the settlement of trades (section 8-507), and the pre-liquidation duty to transfer the account to another securities intermediary (section 8-508). None relates to the right of a customer to enforce fraudulent and fictitious account statements.

The NYUCC also fails to insulate transferees from being sued if they do not take "for value." A rule that "all customers get their securities back in every situation" is not only impractical, but not supported by the UCC. James S. Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. Rev. 1431, 1514-1517 (1996) (stating that "it would be an

exercise in self-delusion to suppose that we could protect investors who hold through intermediaries by adopting a commercial law regime based on simplistic property concepts of that sort"). Moreover, NYUCC Section 8-502 provides that "[a]n action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien or other theory, may not be asserted against a person who acquires a securities entitlement ... for value and without notice of the adverse claim." Thus, the NYUCC is congruent with section 548(c) of the Bankruptcy Code.

Finally, although a claimant must articulate the basis for a claim and provide public notice of the claim being asserted, Defendants have not done so here. In *In re Lake States Commodities, Inc.*, 253 B.R. 866 (Bankr. N.D. Ill. 2000), the court held that defendants in a fraudulent transfer action must articulate their fraud claim as part of their defenses to the fraudulent transfer suit. *Id.* at 880 (explaining that in a Ponzi scheme, to succeed in its argument that a defendant provided "value" for a fraudulent transfer because it satisfied a potential restitution claim, the defendant must make out a prima facie case for restitution). Defendants have not articulated a basis for a claim under the NYUCC or any other state or federal law. Thus, the fictitious profits listed on account statements are not enforceable obligations and thus cannot constitute "value" under 548(c).

III. UNDER SIPA, A GENERAL CREDITOR CLAIM CANNOT PROVIDE "VALUE" IN EXCHANGE FOR A FRAUDULENT TRANSFER OF CUSTOMER PROPERTY

Defendants assert that the definitions of "value," "debt," and "claim" are not based on the priority of any claim in an insolvency case, and that any "claims" must constitute "value." *See* Def. Mem. at 9. As a preliminary matter, as discussed in section II, *supra*, Defendants' "claims" are not enforceable and therefore cannot constitute "value." Even assuming, *arguendo*, however, that Defendants had enforceable "claims," such claims cannot constitute "value" in this context

because, among other things, they are, at best, against the general creditor estate, and the Trustee is seeking to recover customer property, which is part of a separate, priority fund of customer property.

In a SIPA proceeding, "customers" receive priority treatment to the exclusion of general creditors. *See SIPC v. I.E.S. Mgmt. Group,* 612 F.Supp. 1172, 1177 (D.N.J. 1985), *aff'd w/o opinion,* 791 F.2d 921 (3d Cir. 1986) ("customers" under SIPA receive preferential treatment by being satisfied ahead of general creditors). *See also In re Adler Coleman Clearing Corp.*, 198 B.R. 70, 71 (Bankr. S.D.N.Y. 1996) ("person whose claim against the debtor qualifies as a 'customer claim' is entitled to preferential treatment"); *In re Hanover Square Sec.*, 55 B.R. 235, 237 (Bankr. S.D.N.Y. 1985) ("[a]ffording customer status confers preferential treatment"); *In re Government Sec. Corp.*, 90 B.R. 539, 540 (Bankr. S.D. Fla. 1988) ("customers" under SIPA have "preferred status").

SIPA creates two estates: the general estate and the fund of customer property. *See, e.g.*, SIPA § 78fff-2(c)(1) (providing for the allocation of customer property); § 78fff(d) (providing for apportionment of assets "between [the] general estate and customer property"). Only "customers" can share in customer property. *See* SIPA §78fff-2(c)(1). To the extent of any shortfall in customer property and within limits, the balance of a customer's claim may be satisfied through an advance of SIPC funds. SIPA §78fff-3(a).

In contrast to customers, general creditors are not eligible to share in customer property or in SIPC advances. *See SEC v. F. O. Baroff Co.*, 497 F.2d 280, 282 n.2 (2d Cir. 1974) (stating that customer status is determined by transaction); *In re Stalvey & Associates, Inc.*, 750 F.2d 464, 471 (5th Cir. 1985). *Accord, SIPC v. Associated Underwriters, Inc.*, 423 F.Supp. 168, 171 (D. Utah 1975) ("SIPC is not an insurer, nor does it guarantee that customers will recover their

investments which may have diminished as a result of, among other things, market fluctuations or broker-dealer fraud"); *In re Klein, Maus & Shire, Inc*., 301 B.R. 408, 421 (Bankr. S.D.N.Y. 2003) (claims for damages do not involve the return of customer property entrusted to broker and are not "customer" claims. Claims for damages resulting from misrepresentation, fraud or breach of contract are not protected and are general creditor claims); *In re MV Sec., Inc.*, 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) (no SIPA protection for innocent investor against broker's fraud); *SEC v. Howard Lawrence & Co.*, 1 Bankr. Ct. Dec. (CRR) 577, 579 (Bankr. S.D.N.Y. 1975) (no SIPA protection for claims based on fraud or breach of contract); *In re Oberweis Sec., Inc.*, 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (claim for damages resulting from broker's failure to invest funds as instructed are basis only for general creditor claim); *In re Bell & Beckwith*, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990) (no protection for claims based on broker's fraudulent conduct). While general creditors share in the general estate, if any, it is only in accordance with the priority of distribution under section 726 of the Bankruptcy Code. *See* SIPA §78fff(e).

In the case at hand, the transfers made to the Defendants consisted of customer property. Notwithstanding the priority treatment of customers under SIPA and the fact that general creditors cannot share in customer property, the Defendants argue that the unidentified, speculative, and unproven, general creditor claims that they purport to have properly were satisfied with customer property and therefore, constituted "value" for the transfer. The Defendants' argument is specious, and flies in the face of SIPA.

Finally, the case law relied upon by Defendants has no bearing. *See* Def. Mem. at 10-11. Thus, this Court previously has held *In re Sharp Intern. Corp.*, 403 F.3d 43 (2d Cir. 2005), to be inapplicable because in *Sharp,* the transfer was constructively fraudulent instead of actually

fraudulent, as here. *See Picard v. Katz (In re BLMIS)*, 2011 WL 4448638, at *4 (S.D.N.Y. Sept. 27, 2011). Similarly, Defendants' citation to *In re Manhattan Investment Fund Ltd.*, 398 B.R. 1 (S.D.N.Y. 2007), is irrelevant to an avoidance action against a Ponzi scheme investor. In *Manhattan Investment*, the trustee sought to avoid transfers into a margin account at a securities brokerage, not fictitious profits received by a Ponzi scheme victim. *Id.* at 13-15. The issue of value was not discussed in *Manhattan Investment. Id.* Finally, in *Picard v. Merkin (In re BLMIS)*, 2011 WL 3897970 (S.D.N.Y. Aug. 31, 2011), Judge Wood denied the defendant's motion for leave to appeal, and held that when allegations of bad faith are at issue, "the question of whether a transfer is for 'reasonably equivalent value' is fact-intensive, and usually cannot be determined on the pleadings." *Id.* at *10. Judge Wood made no other rulings relevant to the instant matter.[3]

[3] It bears mention that Defendants contend that "[n]o party disputes that BLMIS owed its customers the securities reflected on confirmations and statements issued to the customers …" Def. Mem. at 6. The Defendants are gravely mistaken. In fact, the "securities" positions were fictitious, having been randomly invented by Bernard Madoff in order to yield, on paper, specific fictitious profits invented by him. Claimants had securities claims, thereby making them eligible for the higher amount of SIPC protection ($500,000 for securities claims versus $100,000 for cash claims) not because they were owed the fictitious securities positions shown on account statements, but because they placed money with the Debtor in order to buy securities and received confirmations of such purchases. *See In re New Times Securities Services, Inc.*, 371 F.3d 68, 86 (2d Cir. 2004).

CONCLUSION

For all of the reasons stated above, calculation of Defendants' receipt of fictitious profits should be determined by looking to the history of transfers made to Defendants throughout their relationship with BLMIS.

Dated: Washington, D.C.
November 4, 2011

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