| **People v Merkin** |
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| 2020 NY Slip Op 32332(U) |
| July 16, 2020 |
| Supreme Court, New York County |
| Docket Number: 450879/2009 |
| Judge: Saliann Scarpulla |
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# SUPREME COURT OF THE STATE OF NEW YORK
# NEW YORK COUNTY

**PRESENT:** **HON. SALIANN SCARPULLA** *Justice* **PART** **IAS MOTION 39EFM**

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THE PEOPLE OF THE STATE OF NEW YORK BY ANDREW M. CUOMO, ATTORNEY GENERAL OF THE STATE OF NEW YORK,

Plaintiff,

- v -

J. MERKIN, GABRIEL CAPITAL CORPORATION, ASCOT PARTNERS L.P. (RELIEF DEFENDANTS), ASCOT FUND LIMITED (RELIEF DEFENDANTS), GABRIEL CAPITAL L.P. (RELIEF DEFENDANTS), ARIEL FUND LIMITED (RELIEF DEFENDANTS), GABRIEL ASSETS LLC (RELIEF DEFENDANTS), GABRIEL ALTERNATIVE ASSETS LLC (RELIEF DEFENDANTS), *** NEW YORK UNIVERSITY,INDIVIDUALLY AND DERIVATIVELY *** (NON-PARTY), ==IRVING H. PICARD, TRUSTEE==(NONPARTY), ***ABN AMRO FUND SERVICES (CAYMAN) LIMITED*** (NON-PARTY), ***MERVYN'S LLC*** (NON-PARTY), ***MERVYN'S HOLDINGS LLC*** (NON-PARTY), ***MERVYN'S BRANDS LLC*** (NON-PARTY), ***BDO CAYMAN ISLANDS*** (NON-PARTY),

Defendant.

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**INDEX NO.** 450879/2009

**MOTION DATE** N/A

**MOTION SEQ. NO.** 033

**DECISION + ORDER ON MOTION**

The following e-filed documents, listed by NYSCEF document number (Motion 033) 981, 982, 983, 984, 985, 986, 987, 988, 989, 990, 991, 992, 994, 995, 1018, 1019, 1020, 1021, 1022, 1023, 1024, 1025, 1026, 1027, 1028, 1029, 1030, 1031, 1032, 1033, 1034, 1035, 1036, 1037, 1038, 1039, 1040, 1041, 1042, 1043, 1044, 1045, 1046, 1047, 1054, 1055, 1056, 1057, 1058, 1059, 1060, 1061, 1062, 1063, 1064, 1065, 1066, 1067, 1068, 1069, 1070, 1071, 1072, 1073, 1074, 1075, 1076, 1077, 1078, 1079, 1080, 1081, 1082, 1083, 1084, 1085, 1086, 1087, 1088, 1089, 1090, 1091, 1092, 1093, 1094, 1095, 1096, 1097, 1098, 1099, 1100, 1101, 1102, 1103, 1104, 1105, 1106, 1107, 1133, 1139, 1144, 1146, 1148

were read on this motion to/for Approve Distribution Methodology.

Upon the foregoing documents, it is

Ralph C. Dawson, the Court-appointed receiver (the "Receiver") for Ascot Partners, L.P. ("Ascot") moves to establish a distribution methodology for the assets of Ascot. Several Investors filed oppositions to this motion: 1) Daniel E. Straus ("Straus"); 2) Ascot limited partners Geraldine Fabrikant, Lynton Asset LP, George Rubin,

Menachem Sternberg and Phyllis Hammer, as Trustee of the Michael Hammer 1993 Marital Trust (collectively "Fabrikant"); 3) Sandalwood Debt Fund A, L.P., Sandalwood Debt Fund B, L.P. and Hudson Investment Partners, L.P. (collectively, "Sandalwood"); and 4) Ascot Fund Limited ("Ascot Fund"). Straus, Fabrikant, Sandalwood and Ascot Fund are collectively referred to as the "Objectors").

**Background**

Bernard L. Madoff Investment Securities ("BLMIS") was revealed as a Ponzi scheme in December 2008. Subsequently, this lawsuit was commenced by the NYAG, in 2009, against J. Ezra Merkin ("Merkin") and Gabriel Capital Corporation ("GCC") and named Ascot as a relief defendant. Merkin was the General Partner of Ascot under the Third Amended and Restated Limited Partnership Agreement of Ascot Partners, L.P. (the "LPA").

In 2009, this Court placed Ascot into receivership, for the Receiver to pursue recovery of Ascot's stolen assets attributable to the Madoff Ponzi scheme, for its Investors' benefit. In fact, Ascot placed virtually all of its Investors' money in BLMIS.

An Amended Order Appointing Receiver, dated May 2, 2013 (the "Receivership Order"), granted to the Receiver "all powers and authority of a receiver at equity," "all powers, authorities, rights and privileges accorded to receivers under the laws of the State of New York" and "all of the rights and powers held under applicable law by the managing Partner and General Partner of Ascot Partners." The Receiver marshalled

approximately $136,000,000 from various sources and now seeks approval for an initial distribution of $120,000,000 to Investors.[1]

In June 2012, the NYAG, Ascot, Ascot Fund Limited, Ariel Fund Limited ("Ariel"), Gabriel Capital L.P. ("Gabriel"), Merkin and GCC entered into a Court-approved settlement of this case (the "Merkin/AG Settlement").

The Department of Justice established the Madoff Victim Fund ("MVF") in 2013. Distributions from the MVF were calculated based on net investment and reduced each victim's amount by any collateral recoveries a victim received, including recoveries from litigation settlements. Further, claims for "lost profits" were not permitted under the MVF. The Receiver states that some MVF funds "have been or may be available" to Ascot Investors.

In the fall of 2018, after analyzing potential plans of distribution, the Receiver held meetings of the Ascot Investor Committee during which members expressed their views. The Receiver states that a "strong majority" of committee members preferred the Net Investment Method ("NIV").

The Receiver moved, by order to show cause, on April 24, 2019, to establish a distribution procedure using the NIV. Sandalwood objected. Following hearings, the

[1] The Receiver's initial distribution dispenses with the bulk of Ascot's funds and sets aside a reserve of approximately $16,000.000 to cover "(1) expenses necessary to defend against challenges to the Receiver's proposals, including any oppositions to this Motion and appeals; (2) potential recoveries by Investors, if any, who successfully appeal the Court's upcoming decisions; (3) other legal and professional fees and operating and wind-down expenses; and (4) unanticipated liabilities or other expenditures."
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Court entered a "Distribution Motion Procedures Order" under which the Receiver then served "Individual Claim Information Sheets" ("ICIS") on Ascot Investors. Each ICIS contained the Investor's financial information and the Receiver's calculation of the Investor's proposed distribution. Investors were required to serve a "Proof of Claim" form that either accepted or objected to the information in their ICIS. Two hundred six Investors accepted and seventeen Investors objected.

The Receiver now moves to establish a distribution methodology and recommends utilizing the NIV to calculate the distribution amounts. The NIV is based on each Investors' actual cash-in and cash-out.

Under the Receiver's approach, each Investor is first allocated $10,000 to ensure that all Investors receive some distribution. Next, each Investor's "Net Investment" is calculated "by subtracting from each Investor's subscriptions, deposits or investments in Ascot ('Subscriptions'), the amount of any redemptions or withdrawals ('Redemptions'), any 'Merkin/AG Settlement Payment,' and any 'Collateral Recoveries.'" Then, the Receiver calculated each Investor's "Pro Rata Percentage" by dividing individual Net Investment amounts by the total of all Investors' Net Investment. Lastly, the Pro Rata Percentages were multiplied against the remainder of the Distribution Amount (net of the $2,270,000 for the $10,000 allocations) and the result was added to the Investors' initial $10,000. According to the Receiver, the majority of Investors will receive more money under the NIV.

The Objectors contest the fairness of the Receiver's distribution plan and instead want distribution amounts to be calculated using the last statement method ("LSM").

Under the LSM, funds are distributed based on the values in Investors' last statements before the fraud was discovered.

**Discussion**

Once a court has determined that a distribution plan is "fair and reasonable, its review is at an end." *S.E.C. v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991). Moreover, courts of equity are not "hampered by the restrictive and inflexible rules which govern common-law courts." *Ripley v. Internal Rys. of Central America*, 8 A.D.2d 310, 328 (1st Dept. 1959). And, the "flexibility of equitable jurisdiction permits innovation in remedies to meet all varieties of circumstances which may arise in any case." *Id.* A court's power, after equity is invoked, "is as broad as equity and justice require." *Nationstar Mortgage, LLC v. Jermaine Francis*, No. 2017-07268, 2020 WL 3816007 at *1, (NY 2d App. Div. Jan. 6, 2020) (internal citation and quotation marks omitted).

Here, the Receiver argues persuasively that NIV is the most equitable method of distribution because it will allow for the most recovery for the largest group of investors. The Receiver notes that NIV has previously been deemed to be the best method to distribute receivership funds in cases involving Ponzi schemes, including the MVF and Madoff Ponzi scheme cases. For example, in *In re BLMIS*, the court approved use of the NIV, despite objectors' advocating use of the LSM, because the former "relies solely on unmanipulated withdrawals and deposits." *In re BLMIS* ("Net Equity Decision"), 654 F.3d 229, 238 (2d Cir. 2011) (internal quotation and citation omitted).

The primary argument raised by all of the Objectors is that the LPA, rather than equity and the Receivership Order, governs the distribution of assets, and the LPA

requires use of the LSM, therefore the Receiver cannot use NIV. Essentially, the Objectors urge me to overlook the fraud that necessitated the creation of the Receivership and treat the distribution in accordance with the LPA's provisions for dissolution. However, this is not a contractual dissolution and the numerous partnership law cases cited by the Objectors are inapposite.[2]

The Second Circuit faced similar objections to a plan of distribution in *In re Tremont Secs. Law, State Law and Ins. Litig.*, 699 F. App'x 8 (2d Cir. 2017). In that case, the Second Circuit assessed the proposed NIV distribution plan on the grounds of whether it was "fair and reasonable," not whether or not it comported with the partnership plans, which provided for allocation of assets proportionally, based on the value of the investors' capital accounts. *Id*. at 13-15. Concluding that the NIV was appropriate, the court found that "[w]hen the funds and their investors signed the Investor Settlement, all assets flowing into the [settlement account] became subject to equitable distribution by the district court." *Id*. at 15. Similarly, in the case before me, the standard to review the proposed plan of distribution hinges on whether or not it's fair and reasonable instead of if it was provided for in the LPA. The Receiver has amply demonstrated the fairness and reasonableness of the NIV.

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[2] These cases include *Congel v. Malfitano*, 31 N.Y.3d 272, 288 (2018); *Lanier v. Bowdoin*, 282 N.Y. 32, 38 (1939); *Mist Properties, Inc. v. Fitzsimmons Realty Co.*, 228 N.Y.S.2d 406 (Sup. Ct. Kings Cty. 1962) and *In re Comcoach Corp.*, 698 F.2d 571 (2d Cir. 1983). Nor do any of the cited cases support the Objectors' position that the LPA still controls even though the partnership has been put in an equity receivership.

Moreover, the Objectors cannot cite to any provision in the LPA requiring me to disregard the fact that some partners benefited from years of fake profits. The LPA simply did not contemplate that all of Ascot's assets would be lost in a massive Ponzi scheme. Thus, the LPA provisions cited by the Objectors, such as Section 3.04, cannot be applied to this unforeseen situation.

In support of their contention that the LSM should apply, the Objectors cite to *Beacon Assocs. Mgmt. Corp. v. Beacon Assocs. LLC I*, 725 F. Supp. 2d 451, 461-63 (S.D.N.Y. 2012) and *Greenspon v. Hurwitz*, No. CL-2014-1584, 2014 WL 10542993 (Va. Cir. Ct. Oct. 24, 2014). Although neither case is binding, they are distinguishable because those courts were assessing methodologies in the context of contractual dissolutions, not equity receiverships as in the case before me. Further, in *Beacon* the "overwhelming majority" of the investors voted to apply the LSM and the investors had "significant" non-Madoff investments and the court did not want to strip investors of the legitimate gains from those investments. *Beacon Assocs. Mgmt. Corp.*, 725 F. Supp. 2d at 463-464. In contrast, Ascot had no legitimate profits and is in an equity receivership.

The Receiver also argues that I should approve the selection of the NIV because, unlike the LSM, the former does not rely on account statements generated by the fraudulent Ponzi scheme which "would result in taking money from certain investors in favor of other investors who, for arbitrary reasons, had been allocated larger amounts of fictitious profits."

In opposition, the Objectors all argue that the cases cited by the Receiver are distinguishable because those cases involved funds that were themselves Ponzi schemes, whereas Ascot was not itself a Ponzi scheme. This is a distinction without a difference because Ascot invested all of the Investors' money in a Ponzi scheme and the result was the same, *i.e.,* the profits credited to Investors' accounts were fictitious. As articulated by the Net Equity Decision, "[u]se of the Last Statement Method… would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations." *In re BLMIS* ("Net Equity Decision"), 654 F.3d 229, 235 (2d Cir. 2011). I agree with the Receiver that a distribution method that gives effect to fictitious profits is not appropriate.

Significantly, the Receiver's distribution methodology is also supported by the office of Letitia James, Attorney General of the State of New York ("OAG"). The OAG's affirmation concluded that the Receiver's approach is fair and equitable as "(a) the NIV method has been blessed by the courts quite uniformly in Ponzi cases, including Madoff-related litigation; (b) this approach reflects the reality of the individual investors' actual damages; and (c) to base distributions on the statements issued by Madoff to Ascot investors would be irrational and unfair, since those statements are fictitious and do not reflect economic (or other) reality."

"An equitable plan is not necessarily a plan that everyone will like." *S.E.C. v. Byers*, 637 F.Supp.2d 166, 168 (S.D.N.Y. 2009) (citation omitted). I am persuaded, however, that the Receiver's choice of NIV is "fair and reasonable" in this case because it

allows for the greatest recovery for the largest group of investors, it was used by numerous other courts in Ponzi scheme cases, and it is not based on fictitious profits.

None of the Objectors' remaining arguments in favor of the LSM require a different conclusion. Ascot Fund claims that its reasonable expectations that the LSM would apply prohibit use of the NIV. The Objectors argue that the settlements in Ariel and Gabriel, and K-1s require me to reject the Receiver's use of NIV. Lastly, the Objectors contend that tax law prevents application of the NIV.

First, there is no legal support for the proposition that investors' expectations trump the Court's equitable powers in choosing a distribution method. Also, as evidenced by the fact that only some Investors have objected, it was simply not the "reasonable expectation" of the pool of Investors that LSM would apply. I note that the expectations argument was rejected in the Net Equity Decision. *In re BLMIS*, 654 F.3d at 236-37, 241. The reasoning in that case applies equally here.

Second, all of the Objectors argue that the fact that the Court-approved distributions for Ariel and Gabriel (other Merkin funds) used LSM is dispositive here. However, unlike the present case, Ariel and Gabriel were approximately 70% invested in legitimate, non-BLMIS investments. Hence, the Ariel and Gabriel distribution method is not germane to which distribution method should apply to Ascot.

Third, the Receiver's distribution of K-1s using certain pre-2008 percentages for efficiency did not entitle the Objectors to believe that the ultimate plan of distribution would be LSM. As the Receiver states in the Reply Memorandum, the "Interim Reports repeatedly informed Investors since 2010 that it was not possible for the Receiver then to

determine a distribution methodology." This, coupled with the fact that any recovery was uncertain until 2018, precludes the Objectors from credibly claiming that the K-1s furnished them with "reasonable expectations" of LSM being the distribution method. The Objectors' other K-1-related arguments of waiver, estoppel and laches are also non-meritorious.

Fourth, the Objectors' argument that tax provisions necessitate rejection of the NIV lacks any support. The Objectors refer to Revenue Ruling 2009-9, which allows Ponzi scheme losses to be deducted as theft losses in the year the fraud is discovered so that earlier years' returns need not be amended. *See* 2009-14 I.R.B. 735, 2009 WL 678990, at *1. Related Revenue Ruling 2009-20 "provides an optional safe harbor method for eligible taxpayers to deduct theft losses" from Ponzi schemes. 2009-14 I.R.B. 749, 2009 WL 678785, at *1. Because it is difficult to know an investor's recovery prospects at the time of the loss's discovery, Revenue Ruling 2009-20 lets investors deduct 75% of losses if they anticipate a possible later recovery and 95% if they do not. *Id*.

According to the Receiver, Ascot took the 75% deduction in anticipation of possible recovery meaning that the Objectors probably benefitted from the deduction of fictitious profits under 2009-20 and, therefore the Objectors should not be allowed to be paid again for the same fake profits. I agree, and further find that none of the tax provisions cited by the Objectors prevent use of a distribution via NIV.

Straus and Sandalwood additionally argue that NIV is inequitable because it permits an "opportunistic investor," Contrarian[3] – which purchased its shares in the secondary market, – to benefit. The Receiver asserts, however, that the majority of Investors, not merely Contrarian, benefit from the NIV. And, that Contrarian is among the Investors that will benefit from the NIV does not make the NIV inequitable.

I have considered the Objectors' remaining arguments and find them unavailing.

Offsets

The Receiver recommends reducing an Investor's Net Investment by any Merkin/AG Settlement payment or other major "collateral recovery" received in connection with their Ascot investment. Further, the plan treats collateral recoveries like Redemptions which reduce the Net Investment instead of imposing a dollar-for-dollar reduction of the Distribution Amount. Because most Investors will not recover all of their net losses, and with only limited funds available for reimbursement, the Receiver states that equity requires taking collateral recoveries into account (as the MVF did).

The OAG supports the Receiver's intent to use funds recovered from the Merkin/OAG settlement as an offset in calculating Investors' net loss in light of the fact that "the OAG's suit against Merkin was designed to (and did) recover money from Merkin for Ascot investors, Ascot's assets were almost entirely invested in Madoff operations, and Merkin settlement moneys were previously distributed on an NIV basis."

[3] Contrarian filed a written statement in support of the Receiver's plan of methodology.

Although the Objectors uniformly oppose NIV and support the LSM, they do not share the same position on offsets. Two Objectors – Ascot Fund and Straus – did not object to offsets. Although Ascot Fund opposes the NIV, its endorsement of the LSM included "offsets for collateral recoveries and those from the Merkin/AG Settlement." Straus stated that if the Court approves the NIV method, he "takes no position on whether an investor's 'Net Investment" should be reduced by any collateral recoveries."

The remaining two Objectors – Sandalwood and Fabrikant – object to offsets. Sandalwood posits that it would be inequitable to offset collateral recoveries. According to Sandalwood, "more ambitious fellow victims" such as itself should not be penalized for recovering losses by having their distribution reduced which, in turn, benefits those Investors who were less proactive in seeking other settlements or bringing other cases.

Fabrikant argues that the LPA does not provide for accounts to be adjusted, or for capital contributions to be reduced by events outside of the Ascot's activities such as the Merkin/NYAG Settlement.

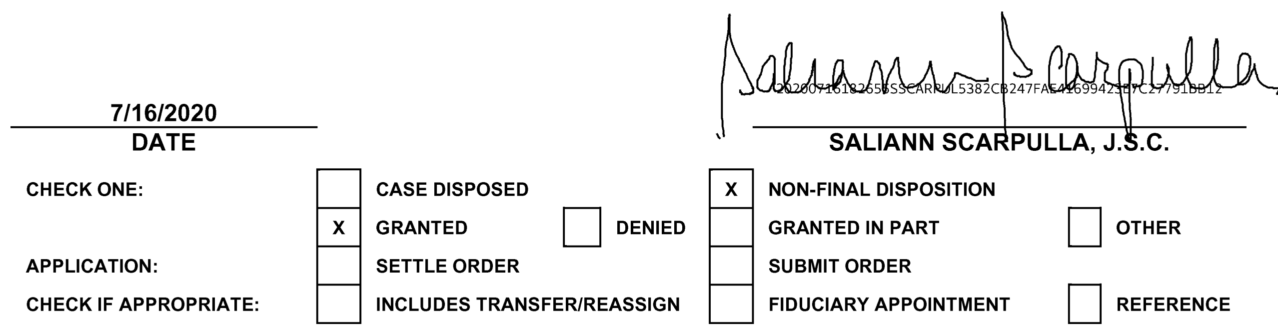
Other courts have approved offsets for collateral recoveries in situations, as in the case before me, where there is limited money to compensate investors. *See SEC v. McGinn, Smith & Co.*, 2016 WL 6459795, at *3–4 (N.D.N.Y. Oct. 31, 2016) (noting that offsets are not inequitable, are "a reasonable solution to allocating limited recoveries," and courts regularly approve offset provisions in plans of distribution); *In re The Reserve Fund Sec. & Derivative Litig.*, 673 F. Supp. 2d 182, 200–01 (S.D.N.Y. 2009). Simply because an Investor deems a collateral offset as inequitable to it personally does not render the offset as inequitable. *McGinn*, 2016 WL 6459795, at *4. Here, the Receiver

deems the offset necessary to prevent some Investors from "double-dipping" while other Investors recover substantially less. The Receiver has thus established that the offsets are equitable and therefore I approve the plan's inclusion of offsets.

In accordance with the foregoing, it is

ORDERED that the motion by the court-appointed Receiver for Ascot Partners, L.P., Ralph C. Dawson, to approve and implement its recommended distribution methodology is granted, and the motions filed by Straus, Fabrikant, Sandalwood and Ascot Fund, in opposition to the Receiver's proposed methodology and for approval of a different methodology, are denied; and it is further

ORDERED that the Receiver submit an order for my signature.



7/16/2020
DATE

SALIANN SCARPULLA, J.S.C.

| CHECK ONE: | [ ] CASE DISPOSED | | [X] NON-FINAL DISPOSITION | |
|---|---|---|---|---|
| APPLICATION: | [X] GRANTED | [ ] DENIED | [ ] GRANTED IN PART | [ ] OTHER |
| | [ ] SETTLE ORDER | | [ ] SUBMIT ORDER | |
| CHECK IF APPROPRIATE: | [ ] INCLUDES TRANSFER/REASSIGN | | [ ] FIDUCIARY APPOINTMENT | [ ] REFERENCE |