# Madoff - Analysis of the Recent Decision Regarding the Scope of SIPA Protection

The Bankruptcy Court has now provided its long-awaited answer as to the scope of the Securities Investors Protection Corporation's ("SIPC") liability for investor accounts with Bernard L. Madoff Investment Securities LLC ("Madoff"). The ruling in favor of Irving Picard, the trustee responsible for the Securities Investor Protection Act ("SIPA") liquidation of Madoff, precludes recovery for many of the victims of Bernard Madoff's infamous ponzi scheme and leaves the scope of SIPA protection uncertain in future cases. The Bankruptcy Court, however, has certified a direct appeal of its March 1st ruling to the Second Circuit Court of Appeals.

By way of general background, when a brokerage firm such as Madoff files for bankruptcy or closes its operations for financial reasons, SIPC may commence liquidation proceedings pursuant to SIPA in which SIPC will seek to recover funds and securities for the debtor-firm's customers (the "Customers"). Generally, the debtor-firm's Customer related assets, primarily securities and cash (the "Customer Property"), are pooled and distributed on a pro rata basis to the extent of each Customer's "Net Equity." Section 78lll(11) of SIPA defines "Net Equity" as follows:

> the dollar amount of the account or accounts of a customer to be determined by -- (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all *securities positions* of such customer . . .; minus (B) any indebtedness of such customer to the debtor on the filing date . . . . (emphasis added)

If there is insufficient Customer Property to make the victims whole, such victims are entitled an advance from SIPC subject to a cap of $500,000 for securities claims, and $100,000 for cash claims.

At issue before the Bankruptcy Court was the Trustee's determination that the amount of each Madoff Customer's Net Equity was the amount of cash deposited by the Customer into its Madoff account (without interest), less the amounts of any cash withdrawals (the "Net Investment Method"). Based on the Trustee's position, those Madoff victims who withdrew, during the lifetime of their accounts with Madoff, more cash than they deposited ("Net Winners") will not receive a SIPC advance irrespective of whether they, in good faith, relied on the fact that their Madoff account statements reflected much larger fictitious "securities positions". Customers unhappy with the Trustee's use of the Net Investment Method argued that the expectations of the victims evidenced by their last Madoff account statement should determine "Net Equity" (the "Last Statement Method").

The Bankruptcy Court ruled in favor of the Trustee, holding that the Net Investment Method was the proper method of determining claims. Specifically, the Bankruptcy Court held that the term "securities positions," as that term is used in SIPA's definition of "Net Equity," can only be determined by reviewing the debtor's books and records to determine actual securities positions held. Madoff's records revealed that no securities were ever purchased, and that the only verifiable amounts in any Customer's accounts were the cash deposited and withdrawn. The Bankruptcy Court relied on two related Second Circuit opinions in *In re New Times Securities Services, Inc*., another case in which the broker had never purchased any securities for its customers. Those decisions had refused to consider Customer expectations as to fictitious "securities" that not only had not been purchased, but that did not actually exist. The SIPC Trustee in *New Times*, however, distinguished such Customers from Customers whose account statements reflected real securities which had never been purchased and applied the Last Statement Method to the latter. In effect, the Bankruptcy Court found that Madoff"s fabrication of trading prices of real securities was equivalent to fabricating holdings of non-existent or fictitious securities. Had Madoff used actual prices as of the reported transaction dates for its fictitious positions, the Last Statement Method would have been consistent with the trustee's determination of Net Equity in *New Times*.

As a precursor of what is yet to come, the Bankruptcy Court further held that the Net Investment Method is consistent with the Trustee's ability to recover from Customers who are Net Winners transfers made in furtherance of a ponzi scheme, while use of the Last Statement Method would authorize SIPC advances to Net Winners that theoretically would be recoverable as fraudulent transfers. The Bankruptcy Court also cited "equity and practicality" as supporting the Net Investment Method. The Court concluded that, if it adopted the Last Statement Method, it would be possible for Net Winners to recoup a greater recovery at the expense of Net Losers.

There is support in the legislative history of SIPA for the protection of investors' legitimate expectations based on account statements irrespective of whether such expectations are based on securities that were never actually purchased. The objecting Customers relied on that legislative history and the very same Second Circuit decisions in *New Times* cited by the Bankruptcy Court (and the Trustee and SIPC) for their position that Madoff's account statements are the records that must be used to compute Net Equity. As a result, the Second Circuit will be tasked with determining whether its prior rulings turned on the unreliability of the account statements or on the impossibility of determining the market value on the petition date of fictional securities, an impossibility not present where the account statements reflect real securities at fictional prices.

Moreover, the Bankruptcy Court's determination that "equity" favored the Net Investment Method, may be subject to debate. Because there is such limited Customer Property, as compared to total claims, most of Madoff's Customer's recoveries will be limited to funds provided by SIPC. Thus, denying the Net Winners' claims will not create any meaningful recovery for the Net Losers. Denial will instead benefit SIPC by substantially reducing the amount of money SIPC would otherwise have to distribute from its reserve. In addition, the Second Circuit may be asked to reconsider whether an interest or cost of funds component is appropriate in the Net Equity calculation, since the Bankruptcy Court rejected the S.E.C.'s suggestion to include one without explanation.

Customers should be mindful that the Bankruptcy Court's decision is silent as to how the Net Investment Method would be applied to Customers that hold accounts in different capacities. It is, thus, critical that the so-called "Net Winners" carefully review their Madoff account statements because (assuming they timely filed multiple SIPC claims) they may still be entitled to some recovery from SIPC, notwithstanding that their aggregate withdrawals exceed their aggregate deposits.

The subject not touched upon in the Bankruptcy Court's decision, which may be considered by the Second Circuit, is how this interpretation of the law comports with both the purpose of SIPA to provide protection that will increase investor confidence in securities firms and the unfairness that the existence of SIPA protection, at least at the early stages, may have facilitated Madoff's fraud. While Madoff's account records were entirely fictitious, most of its Customers did not know that. From their perspective, it is immaterial whether they lost the value of their accounts due to Madoff's fraud or from mismanagement of a legitimate securities business. It seems odd to shift the fraud risk (by limiting coverage) from the agency whose stated purpose is to protect the Customers' expectations to the actual Customers who Congress intended to induce to rely on the SIPC imprimatur in making their investments. Can SIPA serve its purpose if Customers are subject to such risk? Is it fair to Customers to allow SIPC to disclaim liability after the perpetrator of a ponzi scheme has utilized its SIPC membership to lull customers into trusting it? Finally, who is in a better position to detect this type of fraud, individual Customers or the agency created for the purpose of securing investor confidence in the securities markets and protecting such investors from the financial collapse of its members?

In light of the foregoing decision, the limited amount of SIPC insurance in any case and the potential for even greater uninsured Customer losses if a broker-dealer engages in fraud, investors cannot afford to be complacent about the manner in which their investments are held and structured, and the risks associated with such investments. It is important for investors to consult their counsel and investment professionals about the available steps that can be taken to mitigate these risks.

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