16-413-bk(L)

16-420-bk(CON),16-423-bk(CON)

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

In the Matter of: BERNARD L. MADOFF INVESTMENT SECURITIES LLC,

Debtor,

ELLIOT G. SAGOR, EDWARD A. ZRAICK, JR., NANCY ZRAICK, PATRICIA DELUCA, KAREN M. RICH, THERESA R. RYAN, LAWRENCE J. RYAN, CALLIE A. OSTENSON-MURRAY, KELLY BUNCH, ROBERTA SCHWARTZ, BRET PALMER, SLOAN G. KAMENSTEIN, AARON BLECKER, ANGELA TILETNICK, BARBARA ENGEL, BARBARA KOTLIKOFF HARMAN, BEN HELLER, BENJAMIN T. HELLER IRREVOCABLE TRUST, BETH P. FELDMAN, BRUCE N. PALMER, CAROL FISHER,

(*Caption continued on inside cover*)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF IRVING H. PICARD, TRUSTEE-APPELLEE

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Appellants,

—against—

IRVING H. PICARD, Trustee for the Liquidation of
Bernard L. Madoff Investment Securities LLC,

Appellee,

SECURITIES INVESTOR PROTECTION CORPORATION,
Statutory Intervenor pursuant to Securities Investor Protection Act,
15 U.S.C. Section 78eee(d),

Intervenor.

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PRELIMINARY STATEMENT

The Securities Investor Protection Act ("SIPA") requires the Trustee to return customer property to BLMIS customers based on their "net equity." To determine each customer's net equity under SIPA in this unprecedented Ponzi scheme, the Trustee applied the Net Investment Method, balancing a customer's withdrawals and deposits over the life of their account. Certain customers challenged the Trustee's method, arguing that their net equity should instead be based on the fictitious amounts reported on their customer statements. In rejecting this challenge and upholding the Trustee's Net Investment Method as a matter of law, this Court recognized that the Trustee may not pay claims based on fictitious amounts assigned by the fraudster. Instead, the Trustee's method calculates the actual cash deposited and withdrawn from customer accounts, recognizing that customers who have not yet received amounts equal to their principal have a priority claim to the customer property collected by the Trustee.

Unable to receive credit for fictitious profits generated in their own accounts, Appellants now argue that fictitious profits generated in a different BLMIS account should be treated as real cash deposits if BLMIS purported to transfer the fictitious profits into their accounts. Both the bankruptcy court and the district court rejected this argument, agreeing with the Trustee that a customer cannot transfer what he does not have. For each Inter-Account Transfer reported

by BLMIS, the Trustee calculated the net equity of the transferor account at the time of the transfer. To the extent that the transferor account had any principal to transfer, the transferee account was credited up to that amount, and the net equity of the transferor account was correspondingly deducted. But to the extent the transferor account had already exhausted its principal, there was no cash to transfer and no change in either party's net investment. Just like BLMIS's reports of imaginary securities trading, purported "transfers" of fictitious profits were merely adjustments to the fictitious account balances reported by BLMIS.

As both lower courts agreed, fictitious profits cannot be transformed into actual cash by virtue of an internal BLMIS book entry. Requiring that actual principal exist before crediting another account with it is the only method that complies with SIPA, with this Court's prior decisions, and with fairness. The Trustee cannot credit the "profits" from Madoff's fictitious securities trading at the expense of customers who deposited real principal into BLMIS, regardless of whether or not BLMIS purported to transfer those "profits" from one customer's account to another. The methodology used by the Trustee is thus consistent with and a corollary of this Court's *Net Equity Decision*. The district court's decision should be affirmed.

JURISDICTIONAL STATEMENT

The United States Bankruptcy Court for the Southern District of New York has jurisdiction over this case under 15 U.S.C. § 78eee(b)(4).[1] The bankruptcy court entered its order on December 22, 2014 affirming the Trustee's application of the Net Investment Method to all accounts, including those that received one or more Inter-Account Transfers. *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs., LLC (In re Bernard L. Madoff)*, 522 B.R. 41(Bankr. S.D.N.Y. 2014) (the "*Bankruptcy Court Decision*"). The district court, which was vested with appellate jurisdiction over the bankruptcy court's decision pursuant to 28 U.S.C. § 158(a), affirmed the *Bankruptcy Court Decision* through its Opinion and Judgement entered on January 14, 2016. *Diana Melton Trust v. Picard*, 15 Civ. 1151 (PAE), 15 Civ. 1195 (PAE), 15 Civ. 1223 (PAE), 15 Civ. 1236 (PAE), 15 Civ. 1263 (PAE), 2016 WL 183492 *1 (S.D.N.Y. Jan. 14, 2016) (the "*District Court Decision*"). Notices of appeal from the *District Court Decision* were filed with this Court on February 16, 2016. This Court is vested with appellate jurisdiction over the matter pursuant to 28 U.S.C. §§ 158(d) and 1291.

COUNTERSTATEMENT OF ISSUES PRESENTED

1. Did the district court correctly hold that the Trustee's determination to credit Inter-Account Transfers only up to the net principal in the transferor

[1] Subsequent references to sections of the Act shall be denoted as "SIPA § __."

account, disregarding fabricated gains, is consistent with the *Net Equity Decision's* mandate to apply the Net Investment Method?

2. Did the district court correctly hold that the alternative methodology proposed by Appellants, crediting Inter-Account Transfers at full face value even if they were unsupported by any principal, would violate the Net Investment Method by treating fictitious gains as though they were real?

3. Did the district court properly hold that Elliot G. Sagor, an investor in a shared account, was not entitled to have his net equity calculated at an individual level solely because he also had a separate account in his name at BLMIS?

COUNTERSTATEMENT OF FACTS

A. <u>The SIPA Liquidation</u>

On December 11, 2008, federal agents arrested Bernard L. Madoff ("Madoff"), revealing the existence of the largest Ponzi scheme in history. The same day, the Securities & Exchange Commission ("SEC") filed a civil complaint against Madoff and BLMIS alleging that they were operating a Ponzi scheme through BLMIS's investment advisory business. On December 15, 2008, SIPC filed an application under SIPA § 78eee(a)(4)(B), alleging that because of its insolvency, customers of BLMIS needed SIPA protection. The SEC consented to the consolidation of its case with SIPC's action against Madoff. The district court appointed the Trustee under SIPA § 78eee(b)(3) and referred the case to the

bankruptcy court pursuant to SIPA § 78eee(b)(4). On April 13, 2009, certain parties filed an involuntary bankruptcy against Madoff in the bankruptcy court. An interim trustee was appointed and, on June 9, 2009, a consent order was entered substantively consolidating the chapter 7 estate of Madoff with the estate of BLMIS. (A-157-64.)

Upon his appointment, the Trustee was vested with the powers enumerated by SIPA and the Bankruptcy Code, including the powers to investigate the circumstances of BLMIS's insolvency, to recover funds to maximize the customer property estate, and to equitably distribute those funds to victimized customers with valid calms.

At the inception of the liquidation, the bankruptcy court entered a claims procedures order pursuant to SIPA's statutorily-mandated claims process. *See* Order on the Application for Entry of an Order Approving Form and Manner of Publication and Mailing of Notices, Specifying Procedures for Filing, Determination and Adjudication of Claims; and Providing Other Relief ("Claims Procedures Order"). (A-990-997.) Customers were required to file claims with the Trustee by July 2, 2009. The Trustee then issued a claim determination in writing. Thereafter, the Claims Procedures Order required claimants who disagreed with the Trustee's claim determination to file objections with the bankruptcy court setting forth the bases of their objection. *Id.*

B. Customer Property And Net Equity Under SIPA

While a SIPA liquidation proceeding generally is conducted in accordance with the provisions of the Bankruptcy Code, there are several distinctions, particularly in the claims determination process. Where the two statutory schemes are not consistent, SIPA governs. SIPA § 78fff(b). Unlike an ordinary bankruptcy case, a SIPA liquidation gives priority to payment of customer net equity claims from the customer property estate, as distinguished from claims of general creditors, which are paid from the general estate. *See In re Weis Secs., Inc.*, 73 Civ. 2332, 1976 WL 820, at *5-*6 (S.D.N.Y. Aug. 2, 1976). Customers are entitled to share in customer property up to the amount of their "net equity" (SIPA § 78fff-(2)(c)(1)(B)), which is defined as the amount the broker would have owed to the customer if the broker liquidated the customer's securities positions on the liquidation date, plus the cash deposited by the customer to purchase securities, less any amounts owed by the customer to the broker. SIPA § 78*lll*(11).

Because a "customer" with a "net equity" claim has a priority status, claimants bear the burden of showing that they are entitled to such a priority. *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs., LLC (In re Bernard L. Madoff)*, 515 B.R. 161, 165-66 (Bankr. S.D.N.Y. 2014). For these reasons, the traditional rules in bankruptcy regarding claims allowance and the relative burdens of proof are applicable only as to general creditors, not "customers." *Compare In*

re MF Global Holdings Ltd., Nos. 11-15059 (MG), 11-02790 (MG), 2012 WL 5499847, at *3 (Bankr. S.D.N.Y. Nov. 13, 2012), *with In re Klein, Maus & Shire, Inc.*, 301 B.R. 408, 418-19 (Bankr. S.D.N.Y. 2003). Net equity claims belong only to customers, and are to be paid "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." SIPA § 78fff-2(b).

Accordingly, the Trustee reviewed the more than 16,500 claims submitted to him by evaluating BLMIS's books and records, including reconciling those records internally and with third party sources, to calculate each customer's "net equity" under SIPA.

C. <u>The Net Equity Dispute</u>

Upon his appointment in December 2008, the Trustee began reconciling the books and records of BLMIS and investigating the claims of the debtor. Numerous federal and state agencies also launched investigations. These parallel investigations revealed that BLMIS was used to perpetrate a massive Ponzi scheme in which the funds invested by some customers were used to pay other customers' withdrawal requests. When the scheme collapsed in 2008, money from those BLMIS accounts where deposits exceeded withdrawals (net losers) had been dispersed through the scheme and was in the hands of accountholders who

withdrew more than they deposited (net winners). A small fraction of the amount owed to customers was on hand at the debtor at the time of the collapse.

Although Madoff claimed to execute an investment strategy for customers, in reality, he neither bought nor sold any securities on their behalf. Rather, he merely deposited customer money in a checking account, which he used to pay customer withdrawals. The Trustee examined the books and records of BLMIS, which showed no securities purchases, only the amounts of cash withdrawn and deposited by customers. To perpetuate the fraud, BLMIS fabricated trades on customer statements and other documentation purporting to reflect account activity. The securities trading activity reflected on BLMIS customer statements was based on after-the-fact review of historical trading data and reflected a pattern of continually profitable—and impossible—trades. However, as one might expect in a Ponzi scheme where the customer was presumably aware of the money he or she had put in and taken out, the cash deposits and withdrawals reflected on the customer statements were accurate.

The Trustee therefore concluded that each customer's net equity under SIPA must be calculated by crediting the amount of cash deposited by the customer into their BLMIS account, less any amounts withdrawn from their BLMIS customer account, without regard to fictitious profits reflected on customer account statements. This is referred to as the "Net Investment Method." *Sec. Inv'r Prot.*

Corp. v. Bernard L. Madoff Inv. Secs. LLC (In re Bernard L. Madoff Inv. Secs. LLC), 424 B.R. 122, 125 (Bankr. S.D.N.Y. 2010) (the "*Bankruptcy Court Net Equity Decision*"). The Trustee determined that this method was the only method consistent with SIPA, the Bankruptcy Code and Ponzi scheme case law. Certain customers, however, asserted that they should be entitled to recover the amounts on their last account statement, even though those statements reflected fictitious profits and nonexistent trades (the "Last Statement Method"). *Id.* Unsurprisingly, those who advocated the Last Statement Method were net winners, because that method would allow them to retain amounts they withdrew in excess of their cash deposits and establish a claim to customer property for the balance on their final BLMIS account statement.

Among other things, the advocates of the Last Statement Method argued that their customer statements gave them a right under New York State law, specifically the New York Uniform Commercial Code ("N.Y. U.C.C.") for the account balance reflected on those statements. N.Y. U.C.C. § 8-501 (McKinney 2016). Because Madoff would have been obligated to pay those amounts to them on demand, they asserted that whatever amount was reflected on the statement, whether or not reflected in reality, was an obligation ascertainable from the books and records of the debtor and therefore a basis for net equity under SIPA.

The bankruptcy court dismissed these arguments, and approved the Trustee's Net Investment Method and issued an order affirming his calculation of net equity. *Bankruptcy Court Net Equity Decision*, 424 B.R. at 125. The bankruptcy court observed that "[a]ny dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested," *id.* at 141, and that "the Net Investment Method brings the greatest number of investors closest to their positions prior to Madoff's scheme in an effort to make them whole." *Id.* at 142. In rejecting the Last Statement Method, the bankruptcy court stated:

> It would be simply absurd to credit the fraud and legitimize the phantom world created by Madoff when determining Net Equity. The Net Investment Method is appropriate because it relies solely on unmanipulated withdrawals and deposits and refuses to permit Madoff to arbitrarily decide who wins and who loses. . . . As such, the proper way to determine Net Equity is by adopting the Net Investment Method, which is the only approach that can appropriately serve as a proxy for imaginary securities positions shown on customers' last account statements.

Id. at 140 (citations omitted).

On a direct appeal, this Court affirmed the *Bankruptcy Court Net Equity Decision* as a matter of law, holding that it would be "legal error" for the Trustee to rely on the Last Statement Method. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 241 (2d Cir. 2011) (the "*Net Equity Decision*"). This Court stated that

the Last Statement Method would "aggravate the injuries caused by Madoff's fraud," and that reliance on the fictitious profits shown on customer statements "would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations." *Id.* at 235.

This Court further held that the Net Investment Method was consistent with SIPA because the Trustee's use thereof preserved the separate customer fund for priority distribution to customers who—having withdrawn less money than they deposited—had not yet recovered their principal investments. *Id.* at 238-39. Otherwise, "those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed." *Id.* at 238, 240 ("[I]f customers receive SIPC advances based on property that is a fiction, those advances will necessarily diminish the amount of customer property available to other investors, including those who have not recouped even their initial investment.").

Because this Court found that the Net Investment Method was superior as a matter of law, it noted that it need not consider whether a SIPA trustee has discretion in selecting a method to calculate net equity. It nonetheless recognized that a "a reviewing court could and should accord a degree of deference to such an exercise of discretion so long as the method chosen by the trustee allocates 'net

equity' among the competing claimants in a manner that is not clearly inferior to other methods under consideration." *Id.* at 238 n.7.

On June 25, 2012, the United States Supreme Court denied *certiorari*. *Ryan v. Picard*, 133 S. Ct. 24 (2012); *Velvel v. Picard*, 133 S. Ct. 25 (2012).

D. The Dispute Regarding Time-Based Damages

Explicitly excluded from the *Net Equity Decision* was the question whether net equity under SIPA should be adjusted to account for interest or inflation. In October 2012, after the *Net Equity Decision* became final, the Trustee moved the bankruptcy court for an order affirming his claims determinations, in which he calculated net equity under SIPA using the Net Investment Method with no adjustments for inflation or interest. Various claimants objected, seeking both interest-based and inflation-based adjustments to their net equity claims.

The bankruptcy court agreed with the Trustee's determination that claimants were not entitled to "time-based damages," such as inflation, lost opportunity costs, or other time-based adjustments to their net equity claims. *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC (In re Bernard L. Madoff)*, 496 B.R. 744, 761-62 (Bankr. S.D.N.Y. 2013). On February 20, 2015, this Court affirmed the bankruptcy court's ruling on a direct appeal, explaining that "[u]nder SIPA, Claimants' net equity claims cannot be adjusted to reflect inflation." *See Sec. Inv'r Prot. Corp. v. 2427 Parent Corp. (In re Bernard L. Madoff Inv. Sec.*

LLC), 779 F.3d 74, 81 (2d Cir. 2015) (the "*Time-Based Damages Decision*"). This Court stated that "[b]ecause it is doubtful that the full amount of customer property will be recovered in this case, each dollar allocated to earlier investors in recognition of inflation reduces the amount of principal recovered by later investors." *Id.* at 81 (footnote omitted). Thus, adjusting net equity claims to account for inflation would only favor customers who already have recovered their principal investments, "at the expense of customers who have not yet recovered the property they placed in Madoff's hands." *Id.*

This Court agreed that no inflation or interest adjustment should be applied, holding that any such adjustment is precluded by the terms of SIPA itself. *Id.* at 80-81. Accordingly, neither "the flexibility espoused" in the *Net Equity Decision* nor its statements regarding the Trustee's discretion to select a methodology to calculate net equity were relevant to the case before the Court. *Id.* at 79-80.

E. <u>Inter-Account Transfers</u>

Although the *Net Equity* and *Time-Based Damages Decisions* collectively upheld the Trustee's Net Investment Methodology, certain customers continue to raise challenges to the Trustee's application of that methodology to their BLMIS accounts. At issue in this appeal is the Trustee's method for determining the net equity of accounts that received one or more transfers from another BLMIS account ("Inter-Account Transfers").

An Inter-Account Transfer is a non-cash transaction between BLMIS customer accounts in which no new funds entered or left BLMIS, but instead BLMIS recorded a book entry to internally adjust the balances of those accounts. These book entries did not reflect any transfers of cash because there was no actual movement of cash. Rather, the Inter-Account Transfers merely changed the reported value of the purported equity maintained in BLMIS customer accounts. Inter-Account Transfers from one BLMIS account to another consisted of either: (i) all principal; (ii) all fictitious profit; or (iii) a combination of principal and fictitious profit.

To calculate net equity for accounts with Inter-Account Transfers, the Trustee calculated the actual amount of principal available in the transferor account at the time of the transfer, and credited the transferee account for the same amount (the "Inter-Account Method"). The Trustee ignored any fictitious gains. If the transferor account did not have any principal available at the time of the Inter-Account Transfer, the transferee account was credited with $0 for that transfer. Likewise, if, based on the net equity calculation, the transferor account had principal available at the time of the Inter-Account Transfer, the transferee account was credited with the amount of the Inter-Account Transfer, to the extent of that principal.

More than 400 claimants, including defendants in avoidance actions, objected to the Trustee's claims determinations, challenging the Trustee's treatment of Inter-Account Transfers. Most of these objections seek credit for the Inter-Account Transfer of fictitious gains.

F. Antecedent Debt Decision Applies Net Equity To Inter-Account Transfers

The district court was the first court in these proceedings to specifically consider the application of the *Net Equity Decision* to Inter-Account Transfers, in connection with avoidance actions commenced by the Trustee. *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC (In re Bernard L. Madoff Inv. Sec.)*, 499 B.R. 416 (S.D.N.Y. 2013) (the "*Antecedent Debt Decision*").

On a motion to withdraw the reference by certain defendants, the district court considered whether, under SIPA, a defendant in an avoidance action could assert a defense under section 548(c) of the Bankruptcy Code that they provided value in exchange for transfers from BLMIS of fictitious profits.[2] *Id.* at 428-29. Among other things, the defendants challenged the Trustee's method for accounting for transfers between BLMIS accounts, which affected the value of the account that was the subject of the avoidance action. *Id.* The defendants argued that Inter-Account Transfers should be viewed as two separate transactions—a

[2] Section 548(c) provides a defense to the avoidance of transfers, in that "a transferee . . . of such a transfer . . . that takes for value and in good faith . . . may retain any interest transferred . . . to the extent that such transferee gave value to the debtor . . . ." 11 U.S.C. § 548(c).

withdrawal by the transferor and a deposit by the transferee—such that transfers occurring prior to the two-year statutory reach back period should be treated as principal, constituting value for purposes of the section 548(c) defense. *Id.* The defendants also argued that the Inter-Account Method was unfair because it would provide different treatment to "economically equivalent transactions" depending on whether the "transfer" took place within or outside of BLMIS. *Id.*

The district court disagreed. First, it rejected the defendants' theory that Inter-Account Transfers that included fictitious profits should be treated as principal, reasoning that fictitious profits could not be transformed into principal through an Inter-Account Transfer because "no new value was created by moving these funds between different accounts." *Id.* at 428-29. In reaching this conclusion, the district court relied upon a decision in the Bayou Group bankruptcy, which also involved a Ponzi scheme. *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008) ("*Bayou III*"), *aff'd sub nom in part & rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010) ("*Bayou IV*"). In that case, investors in the Bayou Fund subsequently rolled over their investments in Bayou hedge funds. *Bayou IV*, 439 B.R. at 337-38. The account statements for the transferor Bayou Fund accounts reflected fictitious profits which investors sought to retain, arguing that, in calculating their fraudulent transfer liability, the fictitious profits in the transferor

account should be credited to the transferee hedge fund accounts. *Bayou III*, 396 B.R. at 884. The bankruptcy court disagreed, holding that: "in no event is it appropriate to pile fiction on fiction by deeming these investors' final Bayou Fund account statements, including fictitious profits, to be the value of their investments contributed to the Bayou hedge funds." *Bayou III*, 396 B.R. at 885. The bankruptcy court's reasoning was affirmed in *Bayou IV*. 439 B.R. 284, 338-39.

Second, the *Antecedent Debt Decision* rejected the defendants' argument that the Trustee's treatment of Inter-Account Transfers was an improper overreach of avoidance powers. 499 B.R. at 423-24, 429. Defendants argued that because the Trustee may (as to these customers) avoid only those transfers made within the two years predating the commencement of the BLMIS liquidation, he is not permitted to consider the lack of principal in a transferor account for a transfer that predated this two year reach-back period. *Id.* at 429. The district court disagreed and explained that the timing of an Inter-Account Transfer was irrelevant: "[a]t heart, the substance of these transactions was merely to perpetuate a cycle of artificial profits and further investments; where there was no investment of new principal, even those pre-reach-back-period transfers establishing new accounts failed to provide any new value." *Id.* at 430.

Finally, the *Antecedent Debt Decision* considered and rejected the argument that an Inter-Account Transfer should be treated as a withdrawal and reinvestment

of cash, stating that "although defendants claim that such a transfer may be viewed as a transfer of the right to receive an unavoidable payment from Madoff Securities, that right does not exist as long as the fictitious profits remained with Madoff Securities . . . ." *Id.* at 429.

G. Litigation Of The Inter-Account Transfer Issue

1. The *Bankruptcy Court Decision*

Given the large number of accounts impacted by the Inter-Account Transfer issue, an omnibus proceeding was commenced to address the legal issues on a consolidated basis. *See* Scheduling Order (A-1058-1062.) As ordered by the bankruptcy court, the purpose of the proceeding was to resolve the legal issue raised by objections to the Inter-Account Method in connection with the determination of customer claims. *Id.*

The bankruptcy court validated the Inter-Account Method and held that "increasing [Claimants'] net equity claims by giving them credit for the fictitious profits "transferred" into their accounts contravenes the *Net Equity Decision*." (A-728-756). Applying the review framework described in this Court's *Net Equity Decision*, the bankruptcy court determined that the Inter-Account Method was not "clearly inferior" and in fact was superior to the objecting claimants' approach. Accordingly, the court found the Trustee's approach to be entitled to deference.

The bankruptcy court explained:

> [l]ike the Net Investment Method on which it is based [the Inter-Account Method] . . . ignores the imaginary, fictitious profits . . . and conserves the limited customer pool available to pay net equity claims on an equitable basis. . . . Crediting the Objecting Claimants with the fictitious profits . . . essentially applies the Last Statement Method to the transferors' accounts, and suffers from the same shortcomings noted in the *Net Equity Decision*. It turns Madoff's fiction into a fact.

(A-739.)

Accordingly, the bankruptcy court rejected numerous challenges raised by the claimants. First, it rejected the argument that the Inter-Account Method violates the two-year statute of limitations governing avoidance actions (raised here as a due process issue) because the Inter-Account Method does not disturb or avoid any transfer. Instead, it simply determines the value of what was transferred based on the amount of principal in the transferor's account, consistent with the *Net Equity Decision*. (A-740-41.) Because claimants "received *credit* to their net equity claims based on deposits made into the transferor's account regardless of when they occurred, their net equity claims must be *reduced* by any withdrawals the transferor took no matter when he took them." *Id.* (emphasis added).

The bankruptcy court further rejected arguments that the Inter-Account Method created arbitrary or unfair results when compared with actual withdrawals of funds from BLMIS and re-deposits, observing that "[t]hose victims who did not receive fictitious profits or whose investments actually funded the excess

withdrawals from the transferor accounts would, I suspect, view fairness differently." (A-742.)

Similarly rejected was an argument that the transferors were actually the initial transferees of BLMIS and the transferees were, therefore, subsequent transferees. Claimants argued that when a customer directed BLMIS to transfer funds between two accounts, BLMIS exercised dominion and control over the amounts transferred, making it the initial transferee. As the bankruptcy court made clear, BLMIS did not transfer anything to the transferor account, thus the transferor did not become an initial transferee when the Inter-Account Transfer occurred. The bankruptcy court concluded that "the Inter-Account Method is not concerned with avoiding transfers, and hence, the distinction between initial and subsequent transferees is irrelevant." (A-743.)

The court dismissed the assertion that the Trustee was improperly combining accounts in violation of SIPA and the SIPC Series 100 Rules. The bankruptcy court recognized that because the Trustee calculated the net equity of the transferor and transferee account separately, accounts had not been combined in any manner. (A-745.) Finally, the court found that "the Inter-Account Method does not implicate New York's public policy regarding the finality of transactions," recognizing that a similar argument was considered and rejected in the *Net Equity Decision*. (A-746-748.) Echoing this Court's reasoning, the bankruptcy court

recognized that, in a zero-sum game like the BLMIS Ponzi scheme, "recognizing the transfer of fictitious profits in the interest of finality would allow the Objecting Claimants to reap a windfall at the expense of the other victims of Madoff's fraud." (A-748.)

Appellant Elliot G. Sagor ("Sagor") raised an argument unique to his own situation. Sagor was one of multiple beneficiaries of a transferor BLMIS account, who later opened his own BLMIS account. He argued that the net equity of the transferor account should have been calculated on an individual basis as to each participant, if that participant later had his or her own BLMIS account. Reasoning that "[t]his is another way of arguing that they should be treated as separate customers," Judge Bernstein declined to reach this issue, concluding "the question of whether someone is a SIPA customer is a factual one peculiar to the particular Objecting Claimant. . . . [and] is beyond the scope of the [Inter-Account Transfer Motion]." (A-754.)

The bankruptcy court's order was entered on December 22, 2014. (A-771.) Five appellants filed timely notices of appeal.

2. The *District Court Decision*

On January 14, 2016, the district court issued its Opinion and Order affirming the *Bankruptcy Court Decision*, stating that the Inter-Account Method "is the only method of calculating net equity in the context of inter-account

transfers that is consistent with the Second Circuit's *Net Equity Decision*, and that it is not prohibited by law." *District Court Decision*, 2016 WL 183492 at *2.

The district court explained that because the Trustee must "calculate the sum of the real cash an investor put into an account minus the real cash the investor withdrew," *id.* at *8, under the *Net Equity Decision*, it "logically follows that the recognition of transfers from one BLMIS account to another must, too, be limited by the net principal in the transferring account at the time of transfer." *Id.* at *9. Appellants' preferred approach would result in "treating certain fictitious gains . . . as if they were real . . . [and] give rise to unjustifiable inequities among accounts." *Id.* The district court thus concluded: "Given the Second Circuit's adoption of the Net Investment Method, the Trustee's Inter-Account Method is a necessary corollary. . . . It is . . . the superior method as a matter of law for calculating net equity in the context of inter-account transfers." *Id.* at *10.

The district court also agreed that the Trustee's methodology was not a disguised avoidance action and did not violate Appellants' due process rights, stating that "[d]ue process is not offended by a dual statutory regime that permits a longer lookback for the purpose of calculating net equity and a shorter lookback period during which avoidance actions are allowed." *Id.* at *13. This is because while "[n]et equity calculations and avoidance actions" are generally related, they "serve different functions," are "governed by separate statutes situated within

different titles of the United States Code," and thus operate in distinct ways." *Id.* at *12. The district court further found the Inter-Account Method to "promote[] SIPA's fairness objectives because, like the Net Investment Method, it prioritizes the recovery of money for net losers—those who have yet to recover their principal invested." *Id.* at *15. Moreover, "SIPA was not designed to provide full protection to all victims of a brokerage collapse, and arguments based solely on the equities are not, standing alone, persuasive." *Id.* at *16 (quoting *Time-Based Damages Decision*, 779 F.3d at 81.)

The district court also agreed that the Trustee was not improperly combining accounts in violation of SIPA, the SIPC Series 100 Rules, and/or SEC regulations, stating: "Nothing in the Inter-Account Method breaches th[e]se rules. It does not impede the right of the transferor or the transferee account to have separate determinations made of their net equity, or of either to make a claim on the customer property estate on the basis of those separate determinations." *Id.* at *16. Similarly, the bankruptcy court was correct in finding that the Inter-Account Method does not conflict with New York's public policy regarding the finality of transactions. *Id.* at *18. The district court also found unpersuasive Appellants' claims that the Trustee lacked authority to reduce a customer's net equity for any transfers that occurred before January 2001, when BLMIS was formed as a corporate entity. *Id.* at *18-19. The district court stated that this argument "is built

on a false equation of the Inter-Account Method with a statutory avoidance action," and more importantly, the change of corporate form did not "result in any change in ownership or control" of the business and certainly did not "alter the net investments of the customer accounts."[3] *Id.* at *18.

Finally, in contrast to the bankruptcy court, the district court considered Sagor's argument relating to the net equity calculation for his shared account, and rejected it. The district court held that "an investor in a shared account" should not have a "stronger equitable claim on the BLMIS customer estate than others merely because of the happenstance that he had an independent existence (a separate, individual account) within the BLMIS universe." *Id.* at *26.

On February 12, 2016, following the issuance of the district court's Opinion and Order, three appellants timely filed notices of appeal to the Second Circuit.

H. <u>Sagor's Appeal And His Customer Status</u>

Appellant Sagor moves separately to appeal the district court's determination that he is not entitled to additional principal credit based on his investment into a shared account. Sagor appears to concede he is only a "customer" as to his own BLMIS customer account, and not with respect to the shared account for which he was a beneficiary. Nonetheless, he takes issue with

[3] Appellants have abandoned this argument on appeal. In addition, Appellants have abandoned an argument made to the lower courts that ERISA protects the full value of Inter-Account Transfers. Both the bankruptcy court and the district court found that it did not. *District Court Decision*, 2016 WL 183492 at *20-*21; *Bankruptcy Court Decision*, 522 B.R. at 58-59.

the bankruptcy court's statement, and the district court's implicit ruling, that his customer status is, or equitably ought to be, dispositive.

1. <u>Only Customers Have Net Equity Claims</u>

It is uncontested that only those investors that maintained an account at BLMIS, or exhibited other indicia of customer status, are "customers" of BLMIS as defined in § 78*lll*(2) of SIPA. Numerous BLMIS customer accounts were held by feeder funds, pension funds, partnerships, or other entities that had their own investors. Many such investors filed customer claims with the Trustee; where the claimant did not have an account with BLMIS, the Trustee denied their claims on the basis that they were not customers of BLMIS under SIPA. This denial was affirmed by the bankruptcy court, the district court and this Court because the objecting claimants did not have accounts at BLMIS, were not known to BLMIS, lacked any financial relationship with BLMIS and entrusted no cash or securities to BLMIS. *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 454 B.R. 285, 290 (Bankr. S.D.N.Y. 2011); *Aozora Bank Ltd. v. Sec. Inv'r Prot. Corp.*, *(In re Bernard L. Madoff Inv. Secs., LLC)*, 480 B.R. 117, 123-24 (S.D.N.Y. 2012); *Kruse v. Sec. Inv'r Prot. Corp. (In re Bernard L. Madoff Inv. Securities LLC)*, 708 F.3d 422, 426 (2d Cir. 2013) ("'the critical aspect of the 'customer' definition'" is "'the entrustment of cash or securities to the broker-dealer for the purposes of trading securities.'" (quoting *Net Equity Decision*, 654 F.3d at 236)).

2. Sagor Was Not A Customer Of The Transferor Account

From 1990 to 1997, as a partner at the law firm Squadron Ellenoff Plesent & Lehrer, Sagor made contributions to the Squadron Ellenoff Plesent & Lehrer Defined Benefit Pension Plan (the "Squadron Pension Plan"). The Squadron Pension Plan had been invested with BLMIS since 1978, and its administrators opened and maintained Account No. 1L0013 (the "Squadron Account"), in the name of "Stanley I. Lehrer & Stuart M. Stein, JT WROS." (ES-SPA-16-17.) Sagor made contributions totaling $175,000 to the Squadron Pension Plan, which was then invested in the Squadron Account. (ES-SPA-17, 21-26.)

After moving to another law firm, Sagor opened a separate BLMIS Account No. 1S0437 (the "Sagor Account") in the name of "NTC & Co. FBO Elliot G. Sagor." (ES-SPA-5.) On February 22, 2001, $640,682 was transferred from the Squadron Account into the Sagor Account (ES-SPA-37.), and on June 26, 2001, another $15,747 was transferred from the Squadron Account to the Sagor Account. (ES-SPA-37.) At the time of those transfers, the Squadron Account had no principal because it had withdrawn over $30 million more than it had deposited.

On January 6, 2009, Sagor filed a customer claim in connection with the Sagor Account, and then on June 23, 2010 submitted an additional letter with respect to his claim. (ES-SPA-16-34). The Trustee partially allowed Sagor's claim pursuant to the Notice of Trustee's Determination of Claim dated September

22, 2010. (ES-SPA-36-39.) The Trustee explained that the transfers from the Squadron Account were "fictitious gains that were fabricated by BLMIS." (ES-SPA-46.) Sagor then filed an objection to the Notice of Trustee's Determination of Claim on December 21, 2010. (ES-SPA-40-53.) Sagor's participation in the present Inter-Account Transfer proceedings followed.

SUMMARY OF ARGUMENT

The Trustee determined claims using the Net Investment Method, meaning that a customer's net equity (what the customer was owed by BLMIS) was based on the difference between the cash that customers invested with BLMIS and that which they withdrew from BLMIS. This methodology, which disregards fictitious profits arbitrarily assigned by the fraudster, was approved by this Court as a matter of law. The Trustee applied that methodology to determine the net equity for those accounts that received Inter-Account Transfers by similarly disregarding fictitious profits. Accordingly, the transferee account was credited for the transfer only up to the amount of principal in the transferor account on the day of the transfer. Inter-Account Transfers were nothing more than internal book entries at BLMIS—there was no movement of actual cash.

Appellants argue that this approach is improper. They seek to recharacterize Inter-Account Transfers as withdrawals of actual cash and seek credit for the full amount of those transfers as listed on their customer statements. In short, they ask

this Court to ignore the net equity in the transferor account and give them credit for fictitious profits, even though as a matter of law they are not entitled to such credit. Not only is their approach irreconcilable with the *Net Equity Decision*, it is inequitable. Inflating transferee customers' accounts based on fabricated gains from imaginary trading is unfair both to those customers who did not receive Inter-Account Transfers as well as to net losers whose funds would be used to pay these false profits.

Appellants have articulated no viable argument to avoid the application of the *Net Equity Decision* here. Indeed, many of the arguments raised were rejected when this Court rejected the Last Statement Method. Just as the Last Statement Method did not create an obligation requiring the Trustee and SIPC to give effect to fictitious profits from "trading" reflected on a customer statement, an Inter-Account Transfer notation on a customer statement does not create principal where there is none. Similarly, the *Net Equity Decision* approved of a methodology that calculated net equity over the life of the account. Thus, any argument that the statutes of limitation that apply to avoidance actions are relevant to Inter-Account Transfers has already been rejected.

The contention that the Trustee has improperly combined accounts in violation of SIPA or the SIPC Series 100 Rules is also without merit. He has

calculated the net equity of each account separately, based on the reported transactions in each account.

Finally, Sagor's attempt to recover from the estate funds withdrawn from his shared BLMIS account by his former law partners must be denied. Sagor concedes that he was not a customer of the shared account and therefore cannot have his net equity calculated separately from those with whom he shared the account. Thus, regardless of whether or not he later had an account in his name at BLMIS, he cannot create net equity in the shared account where none exists.

STANDARD OF REVIEW

This Court reviews *de novo* the legal conclusions of the bankruptcy court and district court, including the interpretation of SIPA. *In re New Times Secs. Servs.*, 371 F.3d 68, 75 (2d Cir. 2004); *Net Equity Decision*, 654 F.3d at 234. To the extent a trustee uses discretion to select a method to calculate net equity, "a reviewing court could and should accord a degree of deference to such an exercise of discretion so long as the method chosen by the trustee allocates 'net equity' among the competing claimants in a manner that is not clearly inferior to other methods under consideration." *Net Equity Decision*, 654 F.3d at 238, n.7.

ARGUMENT

I. THE INTER-ACCOUNT METHOD IS THE ONLY METHOD CONSISTENT WITH THE *NET EQUITY DECISION* AND SIPA

The district court correctly held as a matter of law that the Inter-Account Method is a corollary of the *Net Equity Decision* and consistent with SIPA and the Appellants' approach is not. Since this Court determined, in 2011, that customers of BLMIS cannot be credited with fabricated investment gains, claimants have put forth argument after argument trying to obtain credit for fictitious profits. Each court that has considered these efforts, whether in the context of time-based damages or now Inter-Account Transfers, has found customers simply are not entitled to amounts beyond the principal they invested with BLMIS.

While the *Net Equity Decision* did not specifically address Inter-Account Transfers, the district court correctly held that decision necessarily dictates the result here. This Court concluded that, in this liquidation, the only equitable basis on which to determine net equity is to look to actual cash invested in a BLMIS account and actual cash withdrawn. Any other approach is fundamentally unfair because it favors one group of victims over another: this is because Madoff never purchased any securities and the supposedly profit-generating trades that appeared on customer's statements were fiction. *Net Equity Decision*, 654 F.3d at 231-32 ("However, Madoff never invested those customer funds." And "[e]ven though a customer's monthly account statement listed securities transactions purportedly

executed during the reporting period and purported individual holdings in various . . . stocks . . . the statement did not reflect any actual trading or holdings of securities by Madoff on behalf of the customer."). Accordingly, the only actual economic realities reflected on the books and records were cash withdrawals and cash deposits. *District Court Decision*, 2016 WL 183492 at *9.

Contrary to Appellants' assertions, an Inter-Account Transfer did not effect the transfer of real cash: unlike a cash deposit into BLMIS, no real cash was received by an account when BLMIS entered an Inter-Account Transfer notation on a customer statement. Instead, an Inter-Account Transfer into an account often included the reported transfer of profits manufactured by Madoff. *Id.* ("Although the BLMIS records do reflect balance transfers made by BLMIS customers, a balance transfer on paper cannot alter the existence, or not, of the real invested funds that are the basis of a customer's net equity under SIPA and the Net Equity Decision.") When BLMIS recorded transfers of fictitious profits between accounts, it was merely adjusting the fictitious balance of those accounts—just as it did when it recorded the fictitious purchase or sale of a security.

Appellants' contention that the Trustee conceded that Inter-Account Transfers are transfers of cash is patently false. The Trustee did not, contrary to Appellant Ryan's and Amici's altered citation to the transcript, agree that an Inter-Account Transfer reflected "the fact of a [cash] transfer." Just the opposite:

Trustee's counsel agreed that the BLMIS records indicate a transfer, the purported amount of which is indicated in the books and records. But that amount was based on fictitious securities activities giving rise to an account balance that was not real.[4] In other words, there was no actual cash transfer. Because they include fabricated gains from fictitious securities activities, Inter-Account Transfers cannot be credited in the face amount appearing on customer statements.

The Inter-Account Method is, as the district court noted, simply a corollary of the Net Investment Method—an application of the Net Investment Method to account transfers. As the district court found, it "logically follows that the recognition of transfers from one BLMIS account to another must, too, be limited by the principal in the transferring account at the time of the transfer." *District Court Decision*, 2016 WL 183492 at *9. Indeed, a customer cannot transfer net equity that it does not have. *See Antecedent Debt Decision*, 499 B.R. at 428-29

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[4] Ryan Br. 10; Amici Br. 11. The actual exchanges was as follows (A-723):

THE COURT: But the transfer was of actual cash, right?

MS. VANDERWAL: We agree that the books and records of BLMIS indicate that a transfer occurs. And the fact of a transfer is indicated in the amounts --

THE COURT: Also the amount is indicated?

MS. VANDERWAL: Right, but the amount is not –it's fictitious. It's a created amount --

THE COURT: Well, the --

MS. VANDERWAL: -- based on fictitious securities' activities in the account that gave rise to an account balance that was not real.

(finding an Inter-Account Transfer does not transform fictitious profits into principal); *Bayou III*, 396 B.R. at 885 (finding it is not appropriate to pile "fiction on fiction" and convert fictitious amounts to legitimate investments).

Appellants' preferred approach, which involves crediting at full value all transfers among BLMIS accounts regardless of real principal, directly contradicts the *Net Equity Decision*. Such an approach would necessarily treat fictitious profits as principal, thereby "undermin[ing] . . . the Net Investment Method." *District Court Decision*, 2016 WL 183492 at *9. Moreover, Appellants fail to identify the source of the funds with which they believe they should be credited. In a Ponzi scheme without sufficient money to repay all victims in full, Appellants' attempt to claim money that can only come from other customers. Appellants are therefore demanding that the Trustee deplete other people's principal to credit them for manufactured gains. Not only would doing so be inequitable, it would result in differing treatment for accountholders, contrary to SIPA and the *Net Equity Decision*. Whether an account was credited with fabricated gains would depend on whether the gains were fabricated within the account (in which case there would be no credit) or fabricated within another customer account (in which case there would be credit), even though no real cash was deposited, withdrawn, or transferred. Such a result cannot be countenanced. *See, e.g.*, *Kusch v. Mishkin (In re Adler Coleman Clearing Corp.)*, No. 98-08203 (JLG), 95-024A, 1998 WL

551972 at *17 (Bankr. S.D.N.Y. Aug. 24 1998) ("[T]he trustee's duty to the SIPA estate as a whole clearly prevails over the interests of any single customer."), *aff'd*, 208 F.3d 202 (2d Cir. 2000).

The Inter-Account Method treats all customers equally, based on the amount of principal in their account, whether by deposit or transfer. It is the only method that comports with the settled principles set forth in the *Net Equity Decision* as well as the statutory definition of net equity in SIPA. SIPA requires that net equity be determined "from the books and records of the debtor . . . or otherwise established to the satisfaction of the trustee." SIPA § 78fff-2(b); *Net Equity Decision*, 654 F.3d at 237. While Appellants may have believed that they were receiving transfers of cash, their subjective views cannot be reconciled to the amount of principal in the transferee account at the time of the transfer, as reflected in BLMIS's books and records. (ES-SPA-73.) Appellants' arguments regarding their "legitimate expectations" were explicitly rejected in the *Net Equity Decision* and can carry no weight here. *Net Equity Decision,* 654 F.3d at 236 (quoting S. Rep. 95-763, at 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 764, 765).

In addition to comporting with the *Net Equity Decision*, the Net Investment Method furthers SIPA's dual mandate to protect investors and the securities market as a whole. By disregarding fictitious profits manufactured by Madoff, the Trustee's method best preserves customer property for distribution to customers

with allowed claims for lost principal. As the district court noted, the Net Investment Method "prevents an outcome in which the claims of net losers are diluted by fabricated gains." *District Court Decision*, 2016 WL 183492 at * 8. The district court correctly found that the Inter-Account Method is the only method that is consistent with SIPA as a matter of law. *Id.* at *4; *see also Net Equity Decision*, 654 F.3d at 241 ("It would therefore have been legal error for the Trustee to 'discharge claims upon the false premise that customers' securities positions are what the account statements purport them to be.") (quoting *Bankruptcy Court Net Equity Decision*, 424 B.R. at 135).

Even if it were not correct as a matter of law, the Inter-Account Method is, as the bankruptcy court found, a proper exercise of the Trustee's discretion because it is superior to Appellants' approach. *See District Court Decision*, 2016 WL 183492 at *26, *7 (quoting *Bankruptcy Court Decision*, 522 B.R. at 53); *Net Equity Decision*, 654 F.3d at 238 n.7 (reasoning that trustee entitled to a degree of deference in the exercise of discretion if method chosen is not clearly inferior to other proposed methods). The Trustee's methodology is simple. He reviewed the books and records of the debtor. He ignored the fictitious trading and he gave credit to transferee accounts up to the amount of principal available. The alternative methodology proposed by Appellants is in direct conflict with the *Net Equity Decision*. Indeed, Appellants' approach is an application of the Last

Statement Method to transfers between BLMIS accounts because it credits the fictitious profits created by Madoff at the expense of net losers who have not yet recovered their principal. *Bankruptcy Court Decision*, 522 B.R. at 53 (Appellants' method "aggravates the injury to those net losers who did not receive transfers of fictitious profits by diminishing the amount available for distribution from the limited pool of customer property."). There can be no doubt that the Inter-Account Method is superior to an approach that gives effect to Madoff's fraud. The Trustee's use of the Inter-Account Method comports with the language and purpose of SIPA and the law of this Circuit—the Trustee should thus be accorded deference.

II. THE INTER-ACCOUNT METHOD IS THE ONLY METHOD SUPPORTED BY THE DEBTOR'S BOOKS AND RECORDS AND IT DOES NOT LEAD TO INEQUITABLE RESULTS

A. SIPA Requires The Trustee To Calculate Net Equity Based On All Available Books And Records

Consistent with the mandate provided by the *Net Equity Decision* and SIPA, the Trustee utilized the books and records of BLMIS to identify the amount of principal in a transferor account at the time of an Inter-Account Transfer and gave credit to the transferee account up to the amount of principal available. This Court's rejection of the Last Statement Method necessarily means that Appellants' approach cannot be reconciled with the BLMIS books and records, in that it treats as valid fictitious BLMIS records.

This Court has held that the only portion of BLMIS records that can be relied on to calculate net equity are cash deposits and withdrawals because those entries are unmanipulated and unaffected by Madoff's fraudulent scheme. *Net Equity Decision*, 654 F.3d at 232; *Time-Based Damages Decision*, 779 F.3d at 80 (BLMIS books and records accurately reflect only funds deposited and withdrawn). As the district court correctly noted, the fact that money was deducted from the transferor account and credited to the transferee account is not the point—"a balance transfer on paper cannot alter the existence, or not, of the real invested funds that are the basis of a customer's net equity under SIPA and the *Net Equity Decision*." *District Court Decision*, 2016 WL 183492 at *9. In short, an Inter-Account Transfer can only transfer that which the books and records show a transferor had and cannot transform fictitious profit into principal.

Appellants also argue that the Trustee's use of the debtor's books and records going as far back as 1981 was improper because it took into consideration Inter-Account Transfers completed thirty years before the petition date. However, as discussed below, SIPA requires the Trustee to discharge any obligations owed to customers, to the extent such obligations are "ascertainable from the books and records of the debtor or [are] otherwise established to the satisfaction of the trustee." *Net Equity Decision,* 654 F.3d 229, 237 (quoting SIPA § 78fff-2(b). SIPA "imposes no temporal limit on how far back into the books and records the

Trustee's review may extend. SIPA § 78fff-2(b)." *District Court Decision*, 2016 WL 183492 at *12.[5]

B. The Inter-Account Method Fairly Prioritizes Recovery For Net Equity Customers

Appellants argue that it is unfair that recipients of Inter-Account Transfers are positioned differently than those who received transfers of actual cash, and that the Trustee has failed to "properly exercise[] his discretion to do the right thing in each and every claim." (Sagor Br. at 30.) The Trustee cannot use his discretion to give credit for fabricated gains to some customers at the expense of other customers who have not recovered the amount of their principal investment. The core principal affirmed by courts at every level is that the Net Investment Method is the only way to ensure real dollars are not used to pay claims for fictitious dollars. This Court was clear that it would be improper to "permit[ ] the objecting claimants to recover based on their final account statements, [because] this would 'affect the limited amount available for distribution from the customer property

[5] The date on which the BLMIS fraud began was not an issue below and there is accordingly nothing in the record on appeal with respect thereto. The commencement date of the fraud is a separate issue from the Inter-Account Method. In any event, there is little doubt that the fraud began at least as early as the 1970s. Indeed, former BLMIS employee David Kugel confessed to helping Madoff execute his Ponzi scheme as early as the 1970s. *See* Plea Allocution of David L. Kugel, *United States v. Kugel*, No. 10-CR-228 (LTS) (S.D.N.Y. Nov. 21, 2011). This Court may take judicial notice of a plea allocution under Federal Rule of Evidence 201. *See, e.g.*, *Scholes v. Lehmann*, 56 F.3d 750, 762 (7th Cir. 1995) (finding that district court properly took notice of plea agreement of Ponzi scheme operator in subsequent civil action against other parties); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1095 (2d Cir. 1995) (taking judicial notice of fraudsters' guilty pleas in subsequent civil action by bankruptcy trustee).

fund.'" *Net Equity Decision*, 654 F.3d at 238 (citing *Bankruptcy Net Equity Decision,* 424 B.R. at 133.) Quoting Judge Lifland, this Court reiterated that, "[t]he Net Investment Method is appropriate because it relies solely on unmanipulated withdrawals and deposits and refuses to permit Madoff to arbitrarily decide who wins and who loses." *Id.* (citing *Bankruptcy Net Equity Decision,* 424 B.R. at 140).

Indeed, allowing the losses of net losers to subsidize net winners would essentially turn this SIPA liquidation into an extension of the Ponzi scheme. Focusing on the economic reality, the bankruptcy court stated:

> [e]quality is achieved in this case by employing the Trustee's method, which looks solely to deposits and withdrawals that in reality occurred. To the extent possible, principal will rightly be returned to Net Losers rather than unjustly rewarded to Net Winners under the guise of profits. In this way, the Net Investment Method brings the greatest number of investors closest to their positions prior to Madoff's scheme in an effort to make them whole.

Bankruptcy Net Equity Decision, 424 B.R. at 142. The Trustee's discretion is not implicated when the net equity calculation is mandated as a matter of law under SIPA, but even if it were, it is the Trustee's duty to utilize a methodology that benefits the customer body as a whole. *See Time-Based Damages Decision*, 779 F.3d at 80.

Appellants point to several examples of results that they argue are unfair. The Trustee and courts at every level have recognized that good faith net winners, like good faith net losers, were victims of Madoff's fraud. There is, however, only a limited pool of resources and the Trustee's obligation is to distribute them as equitably as he can among all customers. As the bankruptcy court observed "[t]hose victims who did not receive fictitious profits or whose investments actually funded the excess withdrawals from the transferor accounts would, I suspect, view fairness differently [than Appellants]." *Bankruptcy Court Decision*, 522 B.R. at 54; *Scholes*, 56 F.3d at 757-58 (investor should not be permitted to benefit from fraud at later investor's expense merely because he was not to blame for fraud); *see also Donnell v. Kowell*, 533 F.3d 762, 779 (9th Cir. 2008). While it may be in the interests of certain individual customers to retain fictitious profits, any methodology that awards such profits is not in the interest of the customer class as a whole because it does not ensure that customers are made whole before others can profit. *See, e.g.*, *Kusch v. Mishkin*, 1998 WL 551972 at *17 (holding that "the trustee's duty to the SIPA estate as a whole clearly prevails over the interests of any single customer").[6]

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[6] Appellants also argue that the fact that taxes were paid by certain of the transferees on the fictitious amount of an Inter-Account Transfer should alter the Trustee's methodology. However, the district court has already ruled that any claims involving taxes paid on gains that never existed are general creditor claims that may be filed against the general estate, stating that "[e]very BLMIS investor did not receive their final BLMIS balance, and thus lost the time-value of their investment, as well as any taxes paid on gains that never existed." *Fox v. Picard (In re*

Finally, Appellants repeatedly assert that the Inter-Account Method is unfair because it contravenes the very purpose of SIPA, which is to promote investor confidence in the securities market and protect customers of securities dealers "from suffering the consequences of financial instability in the brokerage industry." *Securities and Exch. Comm'n v. F.O. Baroff Co., Inc.*, 497 F.2d 280, 281 (2d Cir.1974). But, the purpose of SIPA is not "to provide full protection to all victims of a brokerage collapse." *Sec. and Exch. Comm'n v. Packer, Wilbur & Co., Inc.*, 498 F.2d 978, 983 (2d Cir.1974); *see also In re Bernard L. Madoff*, 496 B.R. at 756 (stating that "SIPC is not an insurer and does not guarantee that customers will recover their investments which may have diminished as a result of . . . market fluctuations or broker-dealer fraud" (internal quotation marks omitted)). While the law cannot fully compensate victims of the Madoff Ponzi scheme for all that was lost, the purpose of SIPA is served by treating customers equally and attempting to recoup the investment of as many as possible. If Appellants' methodology were to be adopted, it would be at the expense of other victims.

The Inter-Account Method treats all customers equally, based on the principal they had in their accounts, and any deviation from this method is neither

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Bernard L. Madoff), 848 F.Supp.2d 469, 480-81 (S.D.N.Y. 2012), *aff'd* 740 F.3d 81 (2d Cir. 2014).

permitted by the Courts, nor appropriate when ensuring fairness in this SIPA liquidation.

III. APPELLANTS' DUE PROCESS RIGHTS ARE NOT IMPLICATED

A. The Net Equity Calculation Is Not Avoidance Of Transfers

Appellants try to escape the conclusion that they have no claim for fictitious profits by conflating the Trustee's calculation of net equity with the avoidance actions he may undertake to satisfy net equity claims. Specifically, Appellants argue that the Inter-Account Method violates their due process rights because it allows the Trustee to reach back beyond the statutory two-year limitation on avoidance actions and take their property without due process of law. (Ryan. Br. at 33). But calculating a customer's net equity does not disturb or avoid a transfer. As both the district court and bankruptcy court found, application of the Inter-Account Method is not equivalent to the avoidance of fraudulent transfers.

While net equity calculations and avoidance actions are generally related in that "each aims to facilitate the return of customer property to customers—they are governed by separate statutes" that "operate in different ways." *District Court Decision*, 2016 WL 183492 at *12. The calculation of net equity is governed by SIPA, and is performed in order "to determine the share of customer property of which a customer is entitled to claim ratably." *Id.* (citing SIPA § 78fff-2(c)(1)(B)) If the customer property is insufficient to satisfy all net equity claims, the Trustee

is then authorized to "recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of Title 11. Such recovered property shall be treated as customer property." SIPA § 78fff-2(c)(3). These avoidance actions are governed by the Bankruptcy Code, which dictates that such actions to avoid fraudulent transfers are limited to those transfers made by the debtor "on or within 2 years before the date of the filing of the [bankruptcy] petition." *District Court Decision*, 2016 WL 183492 at *12 (quoting 11 U.S.C. § 548(a)(1)). Importantly, while an avoidance action seeks to nullify a transfer, *Tronox Inc. v. Kerr-McGee Corp. (In re Tronox Inc.)*, 464 B.R. 606, 612-13 (Bankr. S.D.N.Y. 2013), the Inter-Account Method "merely determines the value of what was transferred based on the net investment in the transferor's account." *Bankruptcy Court Decision*, 522 B.R. at 53.

Appellants attempt to meld the concepts by arguing that the Inter-Account Transfers are "transfers" under Section 101(54) of the Bankruptcy Code, such that the refusal to credit the transfer in full is the equivalent of avoiding actual transfers of cash outside of BLMIS. However, bookkeeping entries on a customer statement are not a "mode . . . of disposing of or parting with . . . property or . . . an interest in property" by BLMIS that the Trustee could pursue under the applicable avoidance provisions. The Trustee cannot sue net winners for internal "transfers"

that they never withdrew from BLMIS, whether of fictitious profit or otherwise. 11 U.S.C. § 101(54); *see* 11 U.S.C. § 548.[7] Amici insist that such a transfer may be viewed as a "transfer of the right to receive an unavoidable payment from Madoff Securities, [but] *that right does not exist as long as the fictitious profits remained with Madoff Securities*, and so the sender had no such right to transfer." *Antecedent Debt Decision*, 499 B.R. at 429 (emphasis added). As the *Net Equity Decision* recognized, the fact that fictitious profits are reflected on a BLMIS customer statement does not, in this case, give a customer a "right" to those fictitious profits at the expense of customers who have not yet received their principal.

Similarly, an Inter-Account Transfer is not an initial transfer that the Trustee "must avoid" in order to "proceed . . . against the transferee as a 'subsequent transfer' (for the amount transferred)." (Amici Br. at 23 n.11). Though it is far from clear, Amici appear to be arguing that transferor accounts are initial transferees of BLMIS and the transferee accounts were, therefore, subsequent transferees. BLMIS did not, however, purport to transfer anything to the transferor account, so even if an Inter-Account Transfer were a "transfer" that could be

[7] *United States v. Schaudt (In re Schaudt)*, cited by the Zraick Appellants in support of their assertion that Inter-Account Transfers constitute "transfers" is inapposite. 2012 Bankr. LEXIS 1223 (Bankr. N.D. Ill. Mar. 16, 2012). There, the "Cash Payments clearly constitut[ing] transfers within the meaning of section 101(54) of the Bankruptcy Code," *id.* at *19, were withdrawals of *actual cash* by the chapter 7 debtor from her personal bank account as opposed to mere book entries. *Id.* at *12-13.

avoided, the transferor would not be an initial transferee. Regardless, as the bankruptcy court ruled, the "Inter-Account Method is not concerned with avoiding transfers, and hence, the distinction between initial and subsequent transferees is irrelevant." *Bankruptcy Court Decision*, 522 B.R. at 55; *see also Picard v. Shapiro,* 542 B.R. 100, 118 (Bankr. S.D.N.Y. 2015) ("The Inter-Account Method does not disturb or avoid the transfer; it merely determines the value of what was transferred based on the net investment in the transferor's account.'" (quoting *Bankruptcy Court Decision*, 522 B.R. at 53)).

B. The Two-Year Reach Back Period Does Not Apply To The Net Equity Determination

There is no legal basis under either the Bankruptcy Code or SIPA to apply the two-year reach back period governing the avoidance of fraudulent transfers to the Trustee's calculation of net equity.[8] This is particularly true because Appellants continue to seek credit for deposits made into transferor accounts more than two years prior to the commencement of this liquidation, while simultaneously attempting to avoid the impact any withdrawals from the transferor

[8] As the district court notes, Appellants conflate two distinct two-year periods at issue: (1) the two-year reach-back period under Section 548(a)(1)(A) of the Bankruptcy Codes "that specifies which pre-filing transfers may be subject to avoidance actions" and (2) the two-year statute of limitations under Section 546(a)(1)(A) "within which a Trustee may bring such an avoidance action." *District Court Decision*, 2016 WL 183492 at *11 n.16. Given that the application of the Inter-Account Method is not an avoidance action and because net equity is calculated over the life of the BLMIS account, the rejection of Appellants' due process argument is not impacted by which two-year period Appellants mean to reference. *Id.*

account had on their accounts. As the district court made clear, "[n]othing in the text of § 548(a)(1) [of the Bankruptcy Code] indicates that the two-year restriction applies to anything other than an avoidance action for fraudulent transfers." *District Court Decision*, 2016 WL 183492 at *12. And SIPA § 78fff-2(b) provides that a trustee's obligations to a customer are to be determined insofar as it is "ascertainable from the books and records of the debtor," and "imposes no temporal limit on how far back into the books and records the Trustee's review may extend." *Id.* (citing SIPA § 78fff-2(b).

To the contrary, this Court's *Net Equity Decision* "expressly contemplates that the Trustee will reduce a customer's net equity for transfers of funds *out of* a BLMIS account—*i.e.*, withdrawals—that occurred beyond the two-year reach-back period. In fact, "[s]uch reductions are part and parcel of the Net Investment Method, which nets all deposits and withdrawals over the life of a BLMIS account." *Id.* (emphasis added) (citing *Net Equity Decision*, 654 F.3d at 233). Thus, while the *Net Equity Decision* did not directly address Inter-Account Transfers, it did "definitively reject[] claimants' argument that transfers more than two years before the petition date cannot be used to reduce a customer's net equity without violating § 548(a)(1)'s limitations." *Id.* at *13.

The district court similarly confirmed in the *Antecedent Debt Decision* that the timing of an Inter-Account Transfer does not matter for purposes of calculating

net equity, stating that "there is no time limit on what constitutes 'value' for purposes of section 546(c) . . . ." 499 B.R. at 429. The district court rejected claims that Inter-Account Transfers that occurred earlier than the two years preceding the petition date should be treated as principal, explaining that fictitious profits could not be transformed into principal through an Inter-Account Transfer, as "no new value was created by moving these funds between different accounts." *Id.* at 429 (citing *Bayou III*, 396 B.R. at 885). The district court further explained that "where there was no investment of new principal, even those pre-reach-back-period transfers establishing new accounts failed to provide any new value." *Id.* at 430. In other words, the Inter-Account Method ascribes "the same zero value to the fictitious profits in the transferor's account that the Net Investment Method ascribes to those fictitious profits in the transferee's accounts." *Bankruptcy Court Decision*, 522 B.R. at 53.

Contrary to Appellants' assertion, the *Antecedent Debt Decision* has not been undercut or overruled by other authority. This Court's decision in *Sec. Inv'r Prot. Corp. v. Ida Fishman Revocable Trust*, 773 F.3d 411 (2d Cir. 2014) (the "*Section 546(e) Decision*") emphasized the difference between an avoidance action and the net equity calculation. *See Section 546(e) Decision*, 773 F.3d at 423. In fact, this Court explicitly distinguished the *Net Equity Decision*, noting that it "interpreted 'net equity' in a manner that would harmonize it with the SIPA

statutory framework as a whole," and that, alternatively, section 546(e), is part of the Bankruptcy Code, not SIPA. *Id.* "This [distinction] is important because, in enacting the Bankruptcy Code, Congress struck careful balances between the need for an equitable result for the debtor and its creditors, and the need for finality." *Id.* (citations omitted).

Appellants' reliance on this Court's decision in *Picard v. Fairfield Greenwich Ltd.*, 762 F.3d 199 (2d Cir. 2014) is also unavailing. In that decision, the Trustee sought to enjoin settlements between BLMIS feeder funds and their customers, contending that the settlements impeded the Trustee's ability to recover fraudulent transfers from the settling feeder fund defendants. This Court affirmed the district court's refusal to enjoin the settlements. *Id.* at 212-13. The decision did not address the value defense at issue in the *Antecedent Debt Decision* nor the overwhelming body of case law holding that value cannot be given for fictitious profits. The *Antecedent Debt Decision* remains valuable authority and supports the application of the Inter-Account Method. *See, e.g.*, *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC (In re Bernard L. Madoff*), 531 B.R. 439, 461–62 (Bankr. S.D.N.Y. 2015) (the "*Omnibus Good Faith Decision*"); *see also District Court Decision*, 2016 WL 183492 at *14 (finding persuasive and "[h]ighly germane" Judge Rakoff's holding in the *Antecedent Debt Decision).*

Appellants' attempts to create a constitutional violation fail. Even assuming, arguendo, that the Trustee could be considered a state actor for purposes of asserting a due process claim, there has been no unconstitutional taking because Appellants merely have had their net equity calculated in accordance with the Net Investment Method. As the district court appropriately concluded, "[d]ue process is not offended by a dual statutory regime that permits a longer lookback for the purpose of calculating net equity and a shorter lookback period during which avoidance actions are allowed." *District Court Decision*, 2016 WL 183492 at *13.

Finally, Appellants have been provided with more than adequate notice and an opportunity to be heard at every stage on the Trustee's net equity calculations. In sum, Appellants' argument fails because "[their] contention elevates a faulty statutory argument to the level of an equally faulty Constitutional claim . . . ." *Bankruptcy Court Decision*, 522 B.R. at 53 n.8.

IV. THE TRUSTEE HAS NOT IMPROPERLY COMBINED CUSTOMER ACCOUNTS

The Inter-Account Method does not improperly combine transferor and transferee accounts. Under SIPA and SIPC's Series 100 Rules, customers who hold accounts in separate capacities are treated separately for purposes of a SIPA advance on a net equity claim. SIPA § 78fff-3(a)(2); 17 C.F.R. §§ 300.100-300.105. Specifically, SIPA provides that "[i]n determining net equity . . . accounts held by a customer in separate capacities shall be deemed to be accounts

of separate customers." SIPA § 78*lll*(11)(C). Further, a customer is entitled to a SIPA advance to the extent "the net equity of each customer exceeds his ratable share of the customer property." SIPA § 78fff-3(a).

Thus, section 78fff-3(a) of SIPA and the Series 100 Rules provide for SIPC advances for the benefit of customers up to statutory limits and allow for separate advances to customers with accounts held in separate "capacities," entitling each account to its own SIPC advance and net equity claim. When accounts are held in the same capacity, the accounts are combined and are given a single claim against the fund of customer property and a single SIPC advance. As the district court correctly held, Appellants have conflated the requirement of separate net equity determinations for accounts held in separate capacities with how that net equity determination is made. *District Court Decision*, 2016 WL 183492 at *16.

The provisions relied upon by Appellants relate solely to the question of whether a separate net equity decision will be made for the account in question. Nothing in the operation of the Inter-Account Method violates these rules. Indeed, the Trustee calculated the net equity for each account, tracking each account's running balance separately. Deposits and withdrawals that took place within a single account were only credited or debited from that account. The transferor and transferee accounts remained separate and their net equity was calculated separately. If the Trustee had combined accounts, he would have credited all

deposits and debited all withdrawals from the two accounts together, made one net equity determination for both accounts and provided an SIPA advance only once to the combined account if the accounts together had a positive net equity. The Trustee did not do so.

The Inter-Account Method is simply used to determine the extent to which an Inter-Account Transfer should be credited with principal to augment net equity of the transferee account. There is, therefore, no basis for Appellants' assertions that the Trustee's approach is improper because it holds the transferee responsible for the lack of principal in the transferor's account. (Amici Br. at 17; Ryan. Br. at 23.) The Trustee is not "blurring the lines between accounts" (Amici Br. at 18.), he is applying the Net Investment Method to a transfer between BLMIS accounts.[9] As the district court held "[l]ooking to the net equity within the transferor account for purposes of this determination does not alter the separateness of the two accounts and of the two customers' net equities." *District Court Decision*, 2016 WL 183492 at *16. The fact that an Inter-Account Transfer occurred does not combine those two accounts contrary to SIPA or SIPC's Rules.

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[9] The Zraick appellants incorrectly assert that the district court did not take into account SIPA §78*lll*(11) which provides that accounts held in different capacities will be deemed to be separate accounts. (Zraick Br. at 27-28.) The district court specifically considered that provision and found that the question of whether a separate net equity calculation is performed or not, is distinct from how that calculation is performed once the determination regarding separateness has been reached. *District Court Decision*, 2016 WL 183492 at *16-*17.

V. FEDERAL, STATE LAW AND PUBLIC POLICY GOVERNING FINALITY IN TRANSACTIONS IS NOT RELEVANT

A. Federal Securities Laws Do Not Require Reliance On Customers' Last Account Statements

Appellants maintain that Rule 10b-10 under the Securities Exchange Act of 1934 requires brokers to provide customers with confirmations of securities transactions, and periodic account statements that are intended to allow investors to verify the terms of their transactions and act as a safeguard against fraud. (Ryan. Br. at 24) (citing Confirmation of Transactions, 59 Fed. Reg. 59612, 56613 (Nov. 17, 1994)). Appellants further assert that this function does not change when a broker is in a SIPA proceeding, and in the event a broker fails, customers are entitled to rely on what the customer has been told by the debtor in written confirmations. (Ryan. Br. at 25).

Appellants are attempting to reargue the *Net Equity Decision,* in which this Court rejected any reliance on the market value of the securities reflected on the last BLMIS customer statements, stating to do so "would have the effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations." *Net Equity Decision,* 654 F.3d at 235. Instead, the Second Circuit favored the Net Investment Method, which was "more consistent with the statutory definition of 'net equity' than any other method advocated." *Id.*

Appellants try to distinguish the *Net Equity Decision* by asserting that was a "narrow exception for the allowance of customer claims under the extraordinary facts alleged by the Trustee," and was not "intended for it to apply to transfers of cash as far back as the 1980s which are indisputably reflected on the debtor's books and records." (Ryan Br. at 26.) However, what the relevant portions of the books and records reflect is the amount of principal available to be transferred, and there is no time limitation on the calculation of net equity. *District Court Decision*, 2016 WL 183492 at *12.

B. New York Statutory Law Has No Bearing On Inter-Account Transfers

Certain Appellants and Amici attempt to make the same argument using state law. They argue that Article 8 of New York's Uniform Commercial Code gave rise to valid obligations owed by BLMIS to its customers, and in order to calculate net equity, the Trustee must properly account for what BLMIS owed to its customers under state law. (Ryan Br. at 27-28; Amici Br. at 17-18.) This exact argument was also unsuccessfully raised by customers arguing in favor of the Last Statement Method in the net equity proceedings.

Any argument that state law entitles customers to amounts on their account statement is entirely inconsistent with the *Net Equity Decision*. Knowing this, Appellants and Amici attempt to argue that this Court's *Section 546(e) Decision* somehow changes this result. They are incorrect. Such obligations are neither

stated nor implied in the *Section 546(e) Decision*. Indeed, that decision reiterated this Court's view of the correctness of the Net Investment Method:

> We said that it would be "absurd" to calculate customers' net equity using BLMIS's fictitious account statements, because that would "have the ... effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations."

Section 546(e) Decision, 773 F.3d at 423.[10]

In any event, any state law, including the N.Y. U.C.C., that is inconsistent with SIPA is of no effect and must yield under the Supremacy Clause of the United States Constitution. *See* U.S. Const., art. VI, cl. 2; *First Fed. Sav. & Loan Ass'n of Lincoln v. Bevill, Bresler & Schulman, Inc. (In re Bevill, Bresler & Schulman, Inc.)*, 59 B.R. 353, 378 (D.N.J. 1986), *appeal dismissed*, 802 F.2d 445 (3d Cir. 1986) (holding that state law that is inconsistent with SIPA is preempted under the Supremacy Clause); *Amer. Sur. Co. of N.Y. v. Sampsell*, 327 U.S. 269, 272 (1946) ("[F]ederal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to his creditors."). The Official Comment to the N.Y. U.C.C. makes its subordination plain. "If the intermediary fails and its affairs are being

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[10] Appellants' reliance on *Visconsi v. Lehman Bros. Inc.*, 244 F. App'x 708 (6th Cir. 2007) in this regard is misplaced and has been specifically rejected in this liquidation because its facts have no application here. *See Picard v. Greiff,* 476 B.R. 715, 725 (S.D.N.Y. 2012). The account statements at issue in *Visconsi* tracked the defendants' funds as if they had been properly invested. *Visconsi*, 244 F. App'x at 713-14. Here, there is "no reliable basis on which to determine how defendants would have benefited from their bargains with Madoff Securities." *Greiff,* 476 B.R. 725.

administered in an insolvency proceeding, the applicable insolvency law governs how the various parties having claims against the firm are treated." N.Y. U.C.C. § 8-503 cmt.1 (2009) (McKinney 2016).

The same is true for Amici's argument that, under state law, the transferees are "bona fide holders" of their individual BLMIS accounts and purportedly have property interests in the full face-value of the Inter-Account Transfers. (Amici Br. at 23-24.) This argument falls flat because it is yet another reiteration of the Last Statement Method. Even if applicable, because it cannot be reconciled with SIPA, this contention cannot carry the day.[11]

Even if state law did apply—which it does not—it is well-settled that a transferee can only receive funds to the extent of the transferor's interest in those funds. *See Neshewat v. Salem*, 365 F.Supp. 2d 508, 524 (S.D.N.Y. 2005), *aff'd*, 194 F. App'x 24 (2d Cir. 2006), *citing Chicago Title Ins. Co. v. Eynard*, 84 Misc. 2d 605, 606, (1st Dept. 1975) (grantee received only such title as the grantor had in the property); *BNP Paribas Mortg. Corp. v. Bank of Am., N.A.,* No. 09-9783, 2013

[11] Cases cited in support of this argument make clear that reliance on this state law concept is conditioned on the absence of an "overriding federal policy." *In re Dreier LLP,* 429 B.R. 112, 125 (Bankr. S.D.N.Y. 2010) (providing that state law or other applicable non-bankruptcy law normally determines the extent of the debtor's interest in property, absent an overriding federal policy); *Butner v. United States,* 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result . . ."); *Raleigh v. Ill. Dep't of Revenue,* 530 U.S. 15, 20 (2000) ("Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.") (citing *Butner*, 440 U.S. at 55).

WL 6484727 (S.D.N.Y. December 9, 2013) (assignee cannot stand in better position than assignor). Because this Court made clear in the *Net Equity Decision* that customers cannot receive credit for the receipt of fictitious profits, a transferor does not have the right to transfer fictitious profits and the transferee does not have the right to receive fictitious profits. *See generally Net Equity Decision,* 654 F.3d 229. Shifting the transferor's fictitious profits to the transferee's account does not provide value to the fictitious profits. *Antecedent Debt Decision*, 499 B.R. at 428-29. Judge Rakoff stated, "The funds at issue are still other people's money, and shifting them among accounts, whether those accounts are owned by the same person or entity or, for example, transfers among family members, does not morph those funds into actual new principal." *Id.*

C. Reliance On Public Policy Has Already Been Rejected By The Courts

The Inter-Account Method does not implicate New York's public policy regarding the finality of transactions. Because the Inter-Account Method does not void any transaction, finality concerns are not at issue. *District Court Decision*, 2016 WL 183492 at *17-*18.

Appellants have repeatedly relied upon the same three cases to support their arguments, namely *Banque Worms v. BankAmerica Intl.*, 77 N.Y.2d 362 (N.Y. 1991), *Commodities Future Trading Commission v. Walsh*, 17 N.Y.3d 162 (N.Y. 2011), and *Simkin v. Blank,* 19 N.Y.3d 46 (N.Y. 2012), but these cases are

inapplicable here. As the bankruptcy court explained "[t]he Inter-Account Method does not implicate New York's public policy regarding the finality of transactions, mistaken or otherwise, or domestic relations settlements." *Bankruptcy Court Decision*, 522 B.R. at 57. The calculation of net equity for an Inter-Account Transfer simply does not concern the issues addressed in these cases—whether transfers were authorized as between two account holders, or whether one of the accountholders should be able to unwind the transaction.

These cases hold that the policy favoring finality "did not permit a bid to *reclaim* money from a party that, unknowingly, had been enriched by a fraud." *District Court Decision*, 2016 WL 183492 at *17 (citing *Banque Worms*, 77 N.Y.2d at 372). For example, *Banque Worms* involved a claim of restitution for erroneously wired funds and a counterclaim for declaratory relief and addressed whether New York's "discharge for value" rule applied to the recipient of erroneously transferred funds, despite a showing of detrimental reliance. 77 N.Y.2d at 366. Meanwhile, the *Walsh* court was primarily concerned with the construction of a marital settlement, insofar as the wife received funds that were the fruits of her ex-husband's Ponzi scheme. 17 N.Y.3d at 168-70. Finally, *Simkin* involved the sufficiency of allegations supporting a claim for reformation based on mutual mistake in relation to a divorce settlement agreement providing for equal division of marital assets—including a BLMIS account. 19 N.Y.3d at 49-51.

"Like a federal avoidance action," these three actions were "disruptive and offend[] obvious finality interests," but these cases do not implicate any issues related to Inter-Account Transfers or the Inter-Account Method, because the "same considerations are not presented by a Trustee's assessments of past [inter-account] transfers for the purpose of making a net equity calculation." *District Court Decision*, 2016 WL 183492 at *17.

To be clear, the Appellants' expectations about the worth of their BLMIS accounts "may be unsettled, but these were unsettled as a result of Madoff's fraud"—not the Trustee. *District Court Decision*, 2016 WL 183492 at * 17 (citing *Net Equity Decision*, 654 F.3d at 235-36) (reasoning that the customers' "legitimate expectations" do not form basis for ascertaining net equity). In a zero-sum game like the BLMIS Ponzi scheme, "recognizing the transfer of fictitious profits in the interest of finality would allow the [Appellants] to reap a windfall at the expense of the other victims of Madoff's fraud." *Bankruptcy Court Decision*, 522 B.R. at 58 (quoting *Net Equity Decision*, 654 F.3d at 241).

VI. MR. SAGOR CANNOT RECEIVE PRINCIPAL FROM AN ACCOUNT WITH NO NET EQUITY

A. Sagor Argues For "Retroactive" Customer Status For Purposes Of Net Equity

Appellant Sagor does not challenge the Inter-Account Method. Instead, he argues that he should be credited with the principal he invested in a shared account

because he later had an individual BLMIS account in his name. At the outset, he concedes that his investment in the shared account did not give him the status of a BLMIS customer for purposes of SIPA: "[i]t would be impossible for Sagor to prove he was either a separate customer or an additional customer of [the Squadron Account]." (Sagor Br. 42.) The Trustee agrees and this should end the inquiry. As both the bankruptcy and district court held, the only way to achieve the result Sagor seeks would be to establish that he was a separate customer of BLMIS in the shared account, in accordance with SIPA. *Bankruptcy Court Decision*, 522 B.R. at 60-61; *District Court Decision*, 2016 WL 183492 at *22.

Only a customer of BLMIS can share in the fund of customer property established by SIPA. *District Court Decision*, 2016 WL 183492 at *24 (finding that the concept of net equity "is keyed to the customer" under SIPA § 78*lll*(2)(A) and the *Net Equity Decision*). Generally, customer status is established when a customer account is held in the claimant's name. This Court has stated that there may be circumstances in which an investor in a shared account has a sufficient financial relationship with a debtor to achieve customer status, if the investor himself "entrust[ed] cash or securities to the broker dealer for the purposes of trading securities." *Kruse*, 708 F.3d at 426. Investors without such a relationship, by contrast, are not customers. Accordingly, the investors in the feeder funds at issue in *Kruse* were not customers, where they "(1) had no direct financial

relationship with BLMIS, (2) had no property interest in the assets that the feeder funds invested with BLMIS, (3) had no securities accounts with BLMIS, (4) lacked control over the feeder funds' investments with BLMIS, and (5) were not identified or otherwise reflected in BLMIS's books and records." *Id.* at 426-27; *see also Sec. Inv'r Prot. Corp. v. Morgan, Kennedy & Co.*, 533 F.2d 1314 (2d Cir. 1976) ("*Morgan Kennedy*").

Sagor, like the feeder fund investors in *Kruse* and beneficiaries in *Morgan Kennedy* had no indicia of customer status, and concededly was not a customer, with respect to the Squadron Account. The customer with respect to that account was the Squadron Pension Plan, which withdrew tens of millions of dollars more than it deposited. Sagor's complaint that it is unfair to lump him in with other innocent investors so as to debit him for their withdrawals could be made by any investor in a shared account, but SIPA's purpose is to prioritize customers. And "[i]n the context of the Madoff Ponzi Scheme, [this Court] has held that SIPA's net equity calculation justifiably prioritizes assuring that customers are returned their principal investments." *District Court Decision*, 2016 WL 183492 at *16.

Indeed, Sagor's argument illustrates why the definition of customer is limited to those who "entrusted securities to the debtor." The Trustee's duty under SIPA is to determine the net equity for each customer as ascertainable from the books and records of the *debtor*, in which visibility is limited to customers. *Kruse*

708 F.3d at 426-27; SIPA § 78lll(2)(A). SIPA does not contemplate having a trustee review the books and records of every customer of the debtor to determine the net equity of the customer's investors—which would be necessary under Sagor's approach.

Although Sagor became a BLMIS customer when he established his individual account, the opening of a new account did not retroactively change the treatment of deposits and withdrawals in a prior account held by a different customer. As the district court held:

> Sagor's status as a customer by virtue of his later-established individual account cannot retroactively change the treatment of deposits that were made, from BLMIS's vantage point, unitarily by the Joint Venture in which Sagor participated with his law partners. And assigning value to a transfer from a shared account that had no net equity to transfer simply because an investor participant in that account had an independent customer relationship with BLMIS would assign value to Madoff's fictitious investment gains, in blatant contravention of the *Net Equity Decision*.

District Court Decision, 2016 WL 183492 at *25.

By arguing that his customer status as to his own account should affect the net equity calculation of the Squadron Account, Sagor misconstrues the purpose of the inquiry into customer status. As the district court correctly held, "[t]he purpose of this inquiry is not to determine eligibility to be credited with an inter-account transfer, but rather how the value of the transfer is calculated under the Inter-

Account Method." *District Court Decision*, 2016 WL 183492 at *25. If there were sufficient principal in the shared account at the time of the transfer, the transferee would be credited with those funds, regardless of whether the transferee had any relationship to the shared account. If there was no principal, the transfer would be valued at zero. Only if the transferee could establish separate customer status vis-à-vis the shared account could the transferee's individual deposits and withdrawals be taken into consideration.

In an attempt to overcome the statutory distinction between customers and non-customers, Sagor argues that because BLMIS used a commingled bank account from which all customers were paid, the BLMIS customer accounts had "only the illusion of separate accounts," undermining the Trustee's application of the Net Investment Method. (Sagor Br. 46-47.) But Sagor misunderstands the difference between BLMIS customer accounts and the bank accounts held by BLMIS. This Court found that the cash deposits and withdrawals for the BLMIS customer accounts, as represented on the customer statements, are reliable for purposes of net equity. As the district court reasoned, because this Court held that the "one aspect of the books and records" of BLMIS "that is accurate is their reporting of the cash deposited and the cash withdrawn from various accounts" the "customer account is . . . an appropriate, and not misleading, unit of measure to determine whether . . . at any given time, [the account] had sufficient net principal

invested to permit a transfer to convey value to a recipient account." *District Court Decision*, 2016 WL 183492 at *25. How BLMIS's bank accounts segregated the funds related to those deposits and withdrawals has no impact on the Trustee's net equity calculations.

Net equity is, by necessity, calculated on an account-by-account basis. As this Court affirmed, the most reliable portion of the BLMIS books and records are those entries indicating a deposit or withdrawal by the customer, it therefore "follows that the net equity calculation is to be made holistically, at the account level." *District Court Decision*, 2016 WL 183492 at *24. Likewise, as the district court held, the net equity value of a transfer between accounts must be calculated at the "level of the transferor 'customer.'" *Id.* Sagor proposes disaggregating the accounts to an individual level, such that any individual investor within the account who was underwater with the accountholder would receive principal credit even if the customer account had no principal left in BLMIS. But because every dollar to one claimant means a dollar less to another claimant, this approach would prioritize these non-customer investors over net loser customers. As the district court correctly held, "creating an exception to the overall Net Investment Method to bolster Sagor's recovery under his approach," *id.* at 24, would lead to the "recognition of fictitious Madoff investment gains" to the detriment of net loser customers and in violation of the Net Investment Method. *Id.* at *26. Because the

Squadron Account had no principal available at the time of the Inter-Account Transfer, it could not transfer money that it did not have.

B. Sagor's "Tweak" Is Not An Appropriate Exercise Of The Trustee's Discretion

Sagor argues that regardless of the general rule, crediting *him* with the principal in the shared account is an adjustment to the Net Investment Method that should be within the Trustee's discretion. Sagor provides no legal support for the proposition that the Trustee has the discretion to alter the court-approved method of calculating net equity, but rather offers a series of rationalizations. (*See* Sagor Br. 26-27.)

First, Sagor notes that the SEC considered various approaches to calculating net equity in this unprecedented Ponzi scheme before settling on the Net Investment Method. His argument seems to be that because the Trustee chose the Net Investment Method, he can similarly choose not to apply it. Alternatively, he suggests that the SEC's use of other methods in connection with other liquidations demonstrates room for disagreement as to the necessity of the Net Investment Method here.[12] Neither argument survives the *Net Equity Decision*. In affirming

[12] Sagor relies on the efforts of the Trustee, the SEC, and SIPC prior to the determination of the Net Investment Method as evidence of the fact that it can now be changed at the Trustee's discretion. *See* Sagor Br. 27-28 (citing a Government Account Office report from March 2012 explaining that the SEC considered the corresponding benefits of both the Net Investment Method and Last Statement Method "throughout 2009" before making its recommendation to SIPC). Sagor provides no support for the premise that this equates to the power for the Trustee to disregard the *Net Equity Decision* and adjust the net equity calculation in individual cases.

the Net Investment Method, this Court stated that while it has "no reason to doubt" the Trustee's discretion to choose a methodology, it did not reach the issue because the Net Investment Method is superior as a matter of law to other identified methodologies. *Net Equity Decision*, 654 F. 3d at 283 n.7. This Court went on to clarify that different cases could well require different methods. *Id*. at 238. This Court already has determined, therefore, that the Net Investment Method is the correct method here as a matter of law even though it may not be warranted in other cases.

Next, Sagor suggests that the Trustee's treatment of accounts open prior to 1981 demonstrates his ability to "tweak" or adjust the Net Investment Method. Again, this argument is mistaken. For certain accounts opened prior to 1981, the books and records identifying cash deposits and withdrawals before 1981 were unavailable. These accountholders were credited with the full amounts identified on their first relevant customer statements. This decision was not an adjustment to the Net Investment Method (or its corollary Inter-Account Method) but an application of it. The determination of net equity must be based on the books and records of the debtor, or otherwise established to the Trustee's satisfaction. SIPA § 78fff-2(b)(2). Without records sufficient to identify principal deposits and withdrawals prior to 1981, the Trustee could not arbitrarily determine which portion of the amounts reflected on the statements represented real cash and which

amounts reflected fictitious profits. By giving credit for the full amount reflected on the statement, the Trustee ensured that no customers were erroneously deprived of principal credit. This assumption provided the Trustee confidence that for the 27 years between 1981 and 2008, each customer has been given full credit for the principal inflows into his account, whether through deposits from outside BLMIS or Inter-Account Transfers of principal.

Finally, Sagor contends that exempting his transfer from the Inter-Account Method does no harm given the magnitude of this case. But allowing exceptions to the Inter-Account Method would likely, contrary to his protestations, open what he describes as the "floodgate of claims." *See District Court Decision*, 2016 WL 183492 at *26. There can be little doubt that any investor who lost his principal in a shared account shares Sagor's view that they should be entitled to a separate net equity determination. While Sagor opines that his separate customer account separates him from other such investors, presumably many would agree with the district court's recognition that:

> an investor in a shared account has no stronger equitable claim on the BLMIS customer estate than others merely because of the happenstance that he had an independent existence (a separate, individual account) within the BLMIS universe.

District Court Decision, 2016 WL 183492 at *26.

The Trustee could be asked to re-determine claims for hundreds of investors in feeder funds, pension funds and other shared accounts, when there is no basis for any such reconsideration. *See District Court Decision*, 2016 WL 183492 at * 26 ("If Sagor's proposal were accepted as a means of generating a more favorable outcome for himself, it logically follows that other [investors in] shared accounts would have a claim for similar treatment").

Although the Trustee is sympathetic to Sagor's circumstances, the equities do not favor Sagor. While Sagor had not withdrawn principal, the other participants in the account withdrew far more cash than was ever deposited in the account. His recourse lies with them. Allowing the shared account to transfer more principal than it had would place it in a "preferred position" as compared to other Madoff customers. *District Court Decision*, 2016 WL 183492 at *26. Because of the limited funds inherent in a Ponzi scheme, this recognition of fictitious gains diminishes the recoveries available for net loser customers who have not yet recouped their principal investments. The Squadron Account and Sagor cannot be favored over other customers. *Kusch v. Mishkin*, 1998 WL 551972 at *17 ("the trustee's duty to the SIPA estate as a whole clearly prevails over the interests of any single customer").

CONCLUSION

The district court and bankruptcy court correctly held that the Net Investment Method applies to the calculation of Inter-Account Transfers, such that credit is only given up to the amount of principal in the transferor account at the time of the transfer when determining each customer's net equity. Based on the foregoing, the Trustee respectfully requests that this Court affirm the *District Court Decision*.

Dated: New York, New York
August 22, 2016

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B), as modified by this Court's order dated March 23, 2016 (ECF No. 40), because this brief contains 16,382 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type style requirements of Federal Rule of Appellate Procedure 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Office Word 2010 in 14-point Times New Roman font.

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