

16-413-bk(L), 16-420-bk(CON), 16-423-bk(CON)

IN THE
United States Court of Appeals
FOR THE
Second Circuit

In Re: 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,

(For continuation of caption, see inside cover)

On Appeal from the United States District Court for the Southern District of New York

BRIEF OF INTERVENOR
SECURITIES INVESTOR PROTECTION CORPORATION

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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 the Securities Investor Protection Act,
15 U.S.C. § 78eee(d),

Intervenor,

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, Intervenor Securities Investor Protection Corporation certifies that it has no corporate parents, affiliates, and/or subsidiaries that are publicly held.

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This appeal arises in the context of a liquidation proceeding under the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa–78lll (“SIPA”).¹ Under SIPA section 78eee(d), the Securities Investor Protection Corporation (“SIPC”) is deemed to be a party in interest as to all matters arising in a SIPA proceeding, with the right to be heard on all such matters.

SIPC submits this brief in opposition to the appeal (“Appeal”) from the decision of the United States District Court for the Southern District of New York (“District Court”) affirming the application of the “Inter-Account Method” by Irving H. Picard, as trustee (the “Trustee”) for the substantively consolidated liquidation proceedings of Bernard L. Madoff Investment Securities LLC (“BLMIS” or “Debtor”) under SIPA, and Bernard L. Madoff (“Madoff”).

In the liquidation of a broker-dealer under SIPA, the trustee works to return to customers the investment held by the broker-dealer on their behalf. The value of a customer’s claim is determined by calculating a customer’s “net equity”—the amount owed by the broker-dealer to the customer minus the amount owed by the customer to the broker-dealer—based upon the broker-dealer’s books and records or otherwise established to the satisfaction of the trustee. SIPA § 78fff-2(b).

BLMIS, however, infamously operated as a Ponzi scheme, where investor withdrawals were funded by deposits from new investors. No securities were

¹ For convenience, future references to provisions of SIPA shall omit “15 U.S.C.”

purchased for customers' accounts, and any securities positions and resulting profit reflected on a customer's account statements were purely fictitious. Thus, "profits" in any customer account were pre-ordained by Madoff, who ascribed backdated prices to fictitious securities. BLMIS never maintained custody of customers' investments; those investments were effectively stolen as soon as they were deposited. Within this context, this Court previously approved the Trustee's formula for determining a BLMIS customer's net equity by using the "Net Investment Method," which calculates the total deposits minus the total withdrawals. In doing so, this Court rejected the position that a customer's net equity should include fictitious profits generated on paper by Madoff in furtherance of his Ponzi scheme.

In the present matter, the Trustee seeks court approval of the logical application of the Net Investment Method to the net equity calculation of transfers from one BLMIS account to another. Deemed the "Inter-Account Method," the Trustee recognizes such inter-account transfers only to the extent that the transferor account had positive net equity—i.e., principal—in the account to transfer. The transferee account's net equity would not be increased, however, by an infusion of fictitious profits accrued by the transferor.

In contrast, the Appellants ask the Trustee to give the transferee accounts the full value of the transfers, even if the funds in the transferor's account consisted

entirely of fictitious profits. This approach, however, only gives effect to and exacerbates Madoff's fraud upon the customers as a whole. The BLMIS Ponzi scheme created undeniable hardships when over \$40 billion in purported equity, relied upon by thousands of customers, disappeared. Unfortunately, that illusory equity was present in the Appellants' inter-account transfers. That does not mean, however, that the Trustee can recognize it as net equity supported by real cash when determining the Appellants' SIPA claims.

The United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") and the District Court approved the Trustee's Inter-Account Transfer Method. This Appeal followed.

STATEMENT OF THE ISSUE

In calculating the net equity of a BLMIS customer's account which received a transfer from another BLMIS account, where such transfer may consist of either principal invested by the transferor or fictitious profits generated in the transferor's account, does the Trustee's Inter-Account Method correctly credit the transferee account's net equity only to the extent that the transferor's account had principal available to transfer, while disregarding the transfer of fictitious profits?

STATEMENT OF THE CASE

On March 31, 2014, the Trustee filed a Motion Affirming Application of Net Investment Method to Determination of Customer Transfers Between BLMIS

Accounts, seeking court approval of the Inter-Account Method and affirmation of his denial of claims which were affected by the Inter-Account Method. (A-241.)

On December 8, 2014, the Bankruptcy Court issued a decision granting the Trustee's Motion. *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 522 B.R. 41 (Bankr. S.D.N.Y. 2014) (the "*Bankruptcy Inter-Account Decision*"). Four appellants or groups of appellants filed and argued appeals to the District Court: (1) the Diana Melton Trust, Dated 12/05/05, Case No. 15 Civ. 1151 (S.D.N.Y.); (2) Edward A. Zraick, Jr., *et al.*, Case No. 15 Civ. 1195 (S.D.N.Y.); (3) Aaron Blecker, *et al.*, Case No. 15 Civ. 1236 (S.D.N.Y.); and (4) Elliot G. Sagor, Case No. 15 Civ. 1263 (S.D.N.Y.). A fifth appellant, Michael Most, withdrew his appeal after briefing issues related to inter-account transfers from an Employee Retirement Income Security Act ("ERISA") account, which some of the remaining parties adopted. (A-1286–89.)

On January 14, 2016, the Honorable Paul A. Englemayer, for the District Court, issued a decision affirming the *Bankruptcy Inter-Account Decision* and denying the appeals. *In re Bernard L. Madoff Inv. Sec., LLC*, Case No. 15 Civ. 1151 (PAE), 2016 WL 183492 (S.D.N.Y. Jan. 14, 2016) (the "*Inter-Account Decision*"). Each of the appellant groups, except for the Diana Melton Trust, filed appeals to this Court.

STATEMENT OF THE FACTS

A. The Placement of BLMIS In Liquidation

On December 15, 2008, upon an application by SIPC, BLMIS, a securities broker-dealer and member of SIPC, was placed in SIPA liquidation by Order of the District Court. The District Court appointed Irving H. Picard, Esquire, as trustee for the firm and, consistent with SIPA section 78eee(b)(4), removed the liquidation proceeding to the Bankruptcy Court.

Procedures for the filing of claims with the Trustee were approved by the Bankruptcy Court. In accordance with SIPA, the procedures provided, among other things, for the submission of claims to the Trustee, a determination by the Trustee of the claims, satisfaction by the Trustee of allowed claims, and an opportunity for any customer who disagreed with the determination of its claim to seek Bankruptcy Court review.

B. The Fraud

BLMIS customers made deposits to, and withdrawals from, their accounts for the purpose of investing in the securities market. BLMIS customers typically received periodic account statements issued on BLMIS letterhead, as well as a “Year-End Summary Report.” The statements and reports reflected numerous securities positions bought and sold by BLMIS for the customer and the dates and prices of the trades. The securities included stocks and U.S. Treasury Bills. In

reality, however, no real trading took place in the accounts. The “purchases” of securities were created within the BLMIS system with backdated prices that were selected in order to yield returns invented by Madoff. Customers never had securities positions, so when these positions were “sold,” the “cash” from the sale was fake. The fake cash, including fake profits, would then be reinvested in new fake securities positions, with fake profits being compounded with each new “purchase” and “sale.”

As in the classic Ponzi scheme, Madoff used new investors’ money to pay previous investors “profits” in order to perpetuate the scam. Any “profits” in the account were phantom profits, the product of Madoff’s imagination. The only real events that occurred in each account—i.e., activity supported by the movement of actual cash or securities—were the customers’ deposits of funds into accounts and their withdrawals. Because no trades were real and no actual profits were generated, withdrawals of funds did not come from a customer’s account. Instead, withdrawals came from other customers. In certain cases, because of the sizeable appreciation of “profits” in the accounts, the total amounts withdrawn by customers exceeded many times over the total amounts they deposited. While fake investments reportedly amounted to a net sum of approximately \$64.8 billion by early December 2008, in reality, the total amount of net funds deposited by

customers with the broker was less than \$20 billion, with no genuine profits and only a small fraction of that left in BLMIS's custody.

Those customers who withdrew their principal before BLMIS failed necessarily did better than other customers, including many who made no withdrawals at all. With their withdrawals from the scheme, some investors not only recovered their principal but received millions of dollars in false profits as well. Other customers, whose monies were used to pay those investors who withdrew their principal and more, have yet to recover the amounts they deposited with the broker.

C. Determination of Claims

Due to the nature of BLMIS's Ponzi scheme, the Trustee determined that the BLMIS account statements reflected fictitious securities and profits and thus could not be relied upon to establish a customer's claim. Instead, the Trustee processed all claims based upon the Net Investment Method. Under this method, the customers' net equity—that is, what they were owed, calculated as the difference between what the broker owes the customer and what the customer owes the broker—was the net amount deposited by them with BLMIS. For customers with a positive net equity, having deposited more than they withdrew, the Trustee allowed the claims as ones for "securities" instead of "cash," making each customer eligible for up to \$500,000 of SIPC protection. *See* SIPA § 78fff-3(a); *see In re New Times*

Sec. Servs., Inc., 371 F.3d 68, 87 (2d Cir. 2004) (“*In re New Times*”). Thus, in addition to having a claim satisfied out of available “customer property” held by BLMIS or recovered by the Trustee, the customer could receive up to \$500,000 from funds advanced to the Trustee by SIPC.

D. The Net Equity Decision

When claimants objected to the Trustee’s use of the Net Investment Method, the Trustee sought the Bankruptcy Court’s approval of his calculation. In opposition, the claimants argued that a customer’s net equity should be calculated by the “Last Statement Method,” which relies upon the last fictitious account statement issued by BLMIS. After briefing and argument, the Bankruptcy Court approved the use of the Net Investment Method.

On direct appeal, this Court determined that the Net Investment Method was the method more consistent with the definition of “net equity” and with the intent to treat customers equally under SIPA. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 235 (2d Cir. 2011) (“*Net Equity Decision*”), *cert. dismissed*, 132 S. Ct. 2712 (2012), and *cert. den.*, 133 S. Ct. 24 and 133 S. Ct. 25 (2012). In contrast, the use of the Last Statement Method would yield inequitable treatment among customers and “have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real.” *Id.* Importantly, this Court also noted that “the Net Investment Method allows the Trustee to make payments based on withdrawals

and deposits, which can be confirmed by the debtor's books and records." *Id.* at 238–39.

E. The Inter-Account Method Motion and the Bankruptcy Court Decision

In the present matter, the Trustee filed a Motion with the Bankruptcy Court seeking approval of his use of the Inter-Account Method when determining claims, such as those filed by the Appellants, where the subject account received a transfer from another BLMIS account. SIPC filed briefs in support of the Motion.

Appellants had accounts at BLMIS which had received transfers from other BLMIS accounts which consisted of either principal or fictitious profits, or both. In determining the Appellants' claims for net equity, the Trustee applied the Inter-Account Method, which provided the Appellants with net equity credit only for the cash Appellants deposited in their accounts or for cash deposited in the transferor's account which was available at the time of the inter-account transfer. In other words, using the Net Investment Method, the Trustee first calculated the amount of principal in the transferor account at the time of the transfer. The Trustee then used the net equity of the transferor account to determine the credit that Appellants received for the transfer into their transferee accounts. The Trustee did not credit the Appellants with any fictitious profits that were transferred.

After full briefing and a hearing, the Bankruptcy Court issued its decision approving of the Trustee's Inter-Account Method. *Sec. Inv'r Prot. Corp. v.*

Bernard L. Madoff Inv. Sec. LLC, 522 B.R. 41 (Bankr. S.D.N.Y. 2014) (“*Bankruptcy Inter-Account Decision*”). The Bankruptcy Court relied upon the holdings in the *Net Equity Decision* and the District Court’s decision in *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, 499 B.R. 416 (S.D.N.Y. 2013) (the “*Antecedent Debt Decision*”), *certification for interlocutory appeal denied*, 987 F. Supp. 2d 309 (S.D.N.Y. 2013). The Bankruptcy Court concluded that the Trustee’s Inter-Account Method is entitled to deference because it “is not ‘clearly inferior,’ and indeed, is superior to the alternative championed by the [Appellants].” *Bankruptcy Inter-Account Decision*, 522 B.R. at 53. The Bankruptcy Court noted the parallels between the shortcomings of the Last Statement Method, as discussed in the *Net Equity Decision*, and the shortcomings of Appellants’ recommended method here. *Id.* Significantly, like the Last Statement Method, the Appellants’ method “aggravates the injury to those net losers who did not receive transfer of fictitious profits by diminishing the amount available for distribution from the limited pool of customer property.” *Id.* at 53–54.

In its ruling, the Bankruptcy Court specifically addressed and rejected each of the arguments raised by the Appellants that (1) the Inter-Account Method violates the two year statute of limitations for fraudulent transfer actions; (2) the Inter-Account Method leads to arbitrary results; (3) the Inter-Account Method

improperly combines accounts and violates federal securities laws; (4) the Inter-Account Method should be rejected because public policy favors finality in business transactions; (5) the Inter-Account method violates ERISA; (6) the Bankruptcy Court lacks constitutional authority to render final judgments; (7) the Trustee cannot disallow transfers that occurred prior to 2001 because BLMIS was a sole proprietorship at that time; and (8) a transferee's net equity claim should not be affected by withdrawals made by other beneficiaries in a shared account.

F. The District Court Decision

Five separate appeals were filed and considered on a consolidated basis. After full briefing and a hearing, the District Court issued the *Inter-Account Decision* on January 14, 2016, affirming the Bankruptcy Court's order approving the Inter-Account Method. *Inter Account Decision*, 2016 WL 183492, at *2. In its analysis, the District Court determined that "[a]lthough the Second Circuit's *Net Equity Decision* does not address the application of the Net Investment Method to inter-account transfers, the logic of that decision all but resolves that corollary issue—and this case." *Id.* at *8. Because the *Net Equity Decision*, at its core, requires the Trustee to perform net equity calculations based upon real cash, it required the Trustee to calculate inter-account transfers based upon real cash as well. *Id.* While the Appellants urged the Trustee to accept the book entries on their statements, "a cardinal premise of the Circuit's *Net Equity Decision* was that

BLMIS's fictitious books and records were all but worthless for SIPA purposes, except for the parts of those records reflecting cash deposits and withdrawals." *Id.* at *9.

The District Court considered and rejected the Appellants' objections that (1) the Inter-Account Method violated the statute of limitations and their due process rights by valuing transfers beyond the two-year reach-back period for avoidance actions, *id.* at 11–14; (2) the "Inter-Account Method produces arbitrary and inequitable results, by treating economically equivalent transactions differently based on the manner or timing with which they were carried out," *id.* at *14–16; (3) "the Inter-Account Method improperly combines accounts," *id.* at *16–17; (4) the Inter-Account Method upends policies favoring finality of transactions, *id.* at *17–18; (5) the Trustee lacked authority to value a customer's net equity based upon transactions that occurred when Madoff operated a sole proprietorship prior to forming BLMIS, *id.* at *18–19; (6) ERISA protects the full value of inter-account transfers, *id.* at *19–21; and (7) the net equity of appellant Elliot Sagor's receipt of an inter-account transfer from a pension plan should be calculated based upon his personal deposits and withdrawals from that plan, *id.* at *21–26.

This Appeal followed, with the Appellants presenting arguments from the District Court briefing related to points (1)–(4) and (7) above. The Appellants appear to have abandoned arguments regarding (5) whether the Trustee has

authority to value transactions from the Madoff sole proprietorship and (6) whether ERISA protects inter-account transfers.

STANDARD OF REVIEW

This Court reviews the legal conclusions of the District Court and the Bankruptcy Court, including the interpretation of SIPA, *de novo*. *In re New Times*, 371 F.3d at 75. In conducting a *de novo* review, “the views of . . . SIPC are ‘entitled to respect, but only to the extent that [they have] the power to persuade.’” *Net Equity Decision*, 654 F.3d at 234 (alteration in original) (quoting *Chao v. Russell P. Le Frois Builder, Inc.*, 291 F.3d 219, 228 (2d Cir. 2002)). To the extent that a trustee must use discretion to implement a method of determining 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.

SUMMARY OF THE ARGUMENT

BLMIS orchestrated a Ponzi scheme in which BLMIS conducted no securities trades, but instead issued customer statements showing fake securities trading and enormous fictitious profits at backdated prices. In accordance with SIPA, the Trustee applied the Net Investment Method to calculating a customer’s net equity by determining the amount deposited by the customer with the

brokerage less the customer's withdrawals. The fictitious amounts created by BLMIS and presented to its customers on customer statements (the basis for net equity under the Last Statement Method) were disregarded. On appeal, this Court approved the Net Investment Method. *Net Equity Decision*, 654 F.3d 229.

The Trustee applied the Net Investment Method to every claim. In certain instances, however, a "deposit" into an account was not an introduction of new, real cash into BLMIS but rather a transfer of "cash" from another BLMIS account, as noted on the account statements. No new real cash, however, was produced or transferred. For these accounts, the Trustee applied the Inter-Account Method. With respect to these transfers between BLMIS accounts, the Trustee credited the transferee with the portion of the transfer, if any, that consisted of principal in the transferor's account. Transferred fictitious profits were disregarded: if the transferred cash was the product of fake trades of securities at backdated prices, no transfer of funds could have occurred, and thus, no credit could be applied. In other words, the transferor account's net equity limited the amount actually transferred to the transferee account. The transferee account would only receive credit for the amount of principal or net equity that the transferor account could have provided. The transferred net equity amount would then be used to calculate the transferee account's net equity.

Appellants argue that this Inter-Account Method is inappropriate. They want the Trustee to account for transfers between BLMIS accounts as transfers of real cash, even if the transferor account contained nothing but fictitious profits. They want the Trustee and this Court to ignore the net equity in the transferor account, and legitimize Madoff's fraud by transforming the transfer of fictitious profits from one BLMIS account to another into a fresh infusion of equity. This transformation is to the detriment of all other BLMIS customers, whose funds were used to support the payment of false profits and whose net equities remain calculated pursuant to the Net Investment Method.

The Bankruptcy Court and the District Court approved the Trustee's Inter-Account Method as a natural extension of this Court's *Net Equity Decision*. When fictitious profits are moved from one BLMIS account to one or more BLMIS accounts, the fictitious profits retain their status as fictitious profits. Profits that do not exist and move only on paper from the transferor's account do not magically become real for the transferee's benefit. Any other result would be inconsistent with the treatment afforded to all other BLMIS customers under the Net Investment Method approved by this Court.

Appellants put forth various arguments in order to sidestep or distinguish the Net Equity Decision and contend that the Trustee should credit the transfer of fictitious profits using the fictitious profits that are on the transferor's BLMIS

statements. Many of these arguments were considered and rejected by this Court when it rejected the Last Statement Method. In the *Net Equity Decision*, this Court found that the last account statement reflecting fictitious profits did not create an allowed customer claim for the underlying securities. So too, here, the transfer of fictitious profits between accounts, noted on account statements, does not create an obligation which the Trustee must honor in his calculation of net equity. Similarly, implicit in the *Net Equity Decision* is the distinction between value and avoidance—that the Trustee does not need to avoid, or be able to avoid, a transfer in order for him to account for it in a net equity valuation. See discussion *infra* Section III.A. Finally, the Appellants argue that the Inter-Account Method improperly combines accounts, in contravention of SIPA and the SIPC Series 100 Rules. The Trustee, however, has obeyed the Rules by separately calculating each customer’s net equity and advancing SIPC protection to each customer separately. In short, the Appellants’ approach to inter-account transfers is merely the latest iteration of the Last Statement Method previously rejected by the Second Circuit in the *Net Equity Decision*, and should be summarily dismissed.

ARGUMENT

I. AN OVERVIEW OF SIPA PROTECTION

A customer's claim in a SIPA liquidation is determined by calculating the customer's "net equity." See SIPA § 78fff-2(c)(1)(B). SIPA section 78lll(11) states, in relevant part:

The term "net equity" means the dollar amount of the account or accounts of a customer, to be determined by-

(A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date all securities positions of such customer (other than customer name securities reclaimed by such customer); minus

(B) any indebtedness of such customer to the debtor on the filing date . . .

SIPA § 78lll(11) (2008). "Customer" status under SIPA is determined on a transaction-by-transaction basis. That an investor is a "customer" as to one transaction does not make him a "customer" for all transactions or amounts claimed. See *SEC v. F. O. Baroff Co.*, 497 F.2d 280, 282 n.2 (2d Cir. 1974) ("*F.O. Baroff*"); *SIPC v. Wise (In re Stalvey & Associates, Inc.)*, 750 F.2d 464, 471 (5th Cir. 1985). Furthermore, SIPA does not promise protection to all customers for the full value of their investment. *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 983 (2d Cir. 1974) ("*Packer Wilbur*"). SIPA's "purpose was to extend relief to certain classes of customer," *id.*, based upon the "securities received, acquired, or held by

the debtor” or “cash [deposited] with the debtor for the purpose of purchasing securities.” SIPA § 78lll(2).

The BLMIS Ponzi scheme—where investors’ cash was stolen upon deposit and no securities were ever actually purchased for their accounts but were confirmed at backdated prices—required a different approach from the typical SIPA liquidation. In the *Net Equity Decision*, this Court considered whether the proper method for calculating the amount owed to a customer was the Net Investment Method, which looks at the net value of a customer’s deposits and withdrawals, or the Last Statement Method, which looks only to the fictitious account statements issued by BLMIS reflecting fictitious profits. This Court determined that the Net Investment Method was “more consistent with the statutory definition of ‘net equity’ than any other method advocated by the parties or perceived by this Court.” *Net Equity Decision*, 654 F.3d at 235. In reaching that conclusion, this Court based its decision on the language of SIPA, the equal treatment of customers under SIPA, and the consequences of viewing the fictitious statements as real. *Id.* at 235.

In its analysis, this Court read in harmony two relevant provisions of SIPA: (i) the definition of “net equity” in SIPA section 78lll(11), and (ii) SIPA section 78fff-2(b), which states that net equity is to be determined in accordance with the books and records of the debtor. *Id.* at 236–37. This Court reasoned that the Net

Investment Method was a better measure of net equity in this case because the statements were rigged “after-the-fact constructs,” and because the recovery of fictitious profits would result in an inequitable treatment among customers—benefiting those who not only had artificially inflated statements but had also already withdrawn their principal. *Id.* at 238. The customers could not claim purchases of securities that the debtor’s books and records revealed had been constructed by Madoff with backdated prices. Furthermore, in accordance with SIPA’s requirements, “the Net Investment Method allows the Trustee to make payments based on withdrawals and deposits, which can be confirmed by the debtor’s books and records.” *Id.* at 238–39.

Second, looking to the purpose and design of SIPA, this Court explained that “[t]he principal purpose of SIPA is to protect investors against financial losses arising from the insolvency of their brokers, [and] to protect capital markets by instilling confidence in securities traders.” *Id.* at 329 (internal quotation marks and citations omitted). SIPC is not an “insurance provider,” and it does not protect against all forms of fraud. *Id.* at 239–40. Rather, the objective of “net equity” is to “achieve a fair allocation of the available resources among the customers,” and the Net Investment Method was the best way considered to achieve that result. *Id.* at 240. In contrast, the Last Statement Method “would have undermined this objective.” *Id.* Not only did the Trustee properly reject the Last Statement Method,

it would “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. The Trustee properly declined to calculate ‘net equity’ by reference to impossible transactions.” *Id.* at 241 (internal quotation marks and citations omitted).

II. THE CLAIMANTS CANNOT RECEIVE CREDIT FOR FICTITIOUS PROFITS FROM INTER-ACCOUNT TRANSFERS

While the *Net Equity Decision* approved the Trustee’s Net Investment Method for calculating the net equity of an account which had only deposits and withdrawals, it did not directly address the calculation of net equity where an account receives a transfer from another BLMIS account. The difficulty in such transfers is that, like the account statements and withdrawals, such transfers may consist of principal deposited by the transferor or fictitious profits generated in furtherance of Madoff’s Ponzi scheme. To address this situation, the Trustee applied the Inter-Account Method, which calculates a transferor’s net equity at the time of the transfer and credits the transferee only to the extent that the transfer is supported by positive net equity (i.e., principal) in the transferor’s account.

To borrow the illustrations used by Judge Bernstein in the *Bankruptcy Inter-Account Decision*:

1. Assume customer A’s statement indicated a balance of \$5 million, but the customer’s actual net investment was only \$2 million (the remaining \$3 million consisting of fictitious profits). If customer A

attempted to transfer the entire \$5 million to customer B, customer B received credit for only \$2 million—the net investment in customer A’s account—leaving customer A’s account with a \$0 balance.

2. Assume, instead, that the same customer A transferred \$1 million to customer B. Since customer A had an account balance of \$2 million computed under the Net Investment Method—enough to cover the entire transfer—customer B received credit for the full \$1 million, and customer A still had an account with a \$1 million balance.

3. Lastly, assume that customer A’s account statement indicated a balance of \$5 million, but consisted entirely of fictitious profits. Customer B would not receive any benefit from an attempted transfer because customer A had \$0 balance in his account under the Net Investment Method at the time of the transfer.

Bankruptcy Inter-Account Decision, 522 B.R. at 48.

Preliminarily, the Trustee’s formulation of the Inter-Account Method is entitled to deference so long as it allocates “net equity” among customers in a manner that is not clearly inferior to competing methods. *Net Equity Decision*, 654 F.3d at 238, n.7. Here, the Inter-Account Method is clearly superior to the formulation posited by the Appellants. The Trustee’s use of the Inter-Account Method comports with the language of SIPA, the purpose of SIPA, and the case law of the Second Circuit. Indeed, the rationale of the *Net Equity Decision* applies with equal force here.

The essential question is how to calculate a customer’s net equity when fictitious profits have been transferred on paper from one BLMIS account to another. “We begin where all such inquiries must begin: with the language of the statute itself” *Net Equity Decision*, 654 F.3d at 236–37 (internal quotations

omitted). The same two provisions considered in the *Net Equity Decision* are directly relevant to the calculation of inter-account transfers here. First, the definition of “net equity” under SIPA section 78lll(11) requires the trustee to determine the amount owed to the customers, and, second, section 78fff-2(b) requires that such information either be ascertainable from the books and records of the debtor or otherwise established to the satisfaction of the trustee. See *Net Equity Decision*, 654 F.3d at 237 (reading the two provisions in concert).

As the *Net Equity Decision* explained, the books and records and other information showed that the “trades” on account statements were backdated and fake, that the “profits” were non-existent, that some investors withdrew more than they deposited into their accounts, and that “securities” “purchased” with fake sales proceeds in fact were never paid for by the customer. *Id.* at 231–33. The same fictions infect inter-account transfers where the transferor account has already withdrawn or transferred its principal, leaving only fake profits generated by fake sales. For the Trustee to ignore what the books and records show and to satisfy net equity claims based *solely* upon fictitious account statements or “transfers,” on paper only, of fictitious profits violates SIPA section 78fff-2(b). The Trustee cannot “calculate ‘net equity’ by reference to impossible transactions.” *Id.* at 241. Because the “profits” were imaginary, no transfer of such amounts could have been made, and thus, a customer’s net equity could not receive credit for what has not

occurred. Instead, the Inter Account Method, like the Net Investment Method, “allows the Trustee to make payments based on withdrawals and deposits, which can be confirmed by the debtor’s books and records.” *Id.* at 239–40.

The inclusion of fictitious profits in the calculation of net equity, as Appellants request, also violates the purpose and design of SIPA. First, SIPC does not provide insurance, and SIPA does not protect against all forms of fraud. *Id.* at 239. It does not protect the fraudulent value of a transfer. Second, the Trustee’s Inter-Account Method is the most consistent method for all customers. Like the situation presented by the *Net Equity Decision*, Appellants’ receipt of advances or a pro rata distribution of customer property based on fictitious profits, whether generated in their account or generated in another account and transferred to them, “will necessarily diminish the amount of customer property available to other investors.” *Id.* at 240. Because Appellants’ theory would render a “fair allocation” impossible, it is inconsistent with the objective of SIPA. *See id.*

The Inter-Account Method also comports with other case law in this Circuit. In addition to the *Net Equity Decision*, the District Court has explicitly recognized, in the context of a fraudulent transfer suit, that inter-account transfers of fictitious profits “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.” *Antecedent Debt Decision*, 499 B.R. at 428–29.

The same argument made by the Appellants was also rejected in *In re Bayou Group, LLC*, 439 B.R. 284, 338–39 (S.D.N.Y. 2010). In that case, a debtor hedge fund sought to recover transfers of fictitious profits paid out to investors as part of a fraudulent scheme. One defendant argued that the rollover from one hedge fund account to another in the same scheme should be calculated as new principal, since it was a new investment from a tax and securities law perspective. *Id.* The court rejected this argument, holding that because the profits transferred to the defendants were fraudulent, the transfers were inflated and could not be “worth what Bayou reported them to be worth at the time.” *Id.* at 339. Accordingly, the court approved the bankruptcy court’s holding that “[i]n no event is it appropriate to pile fiction on fiction by deeming these investors’ final [hedge fund] account statements, including fictitious profits, to be the value of their investments contributed to the . . . hedge funds.” *Id.* at 338 (quoting *In re Bayou Group, LLC*, 396 B.R. 810, 884–85 (Bankr. S.D.N.Y. 2008). The situation is virtually identical here, where the fictitious profits reportedly transferred, if treated as real, would only perpetuate Madoff’s fraud, piling fiction on fiction.

In that vein, courts consistently have recognized that SIPA and rules promulgated thereunder “manifest a design to deny protection to transactions

tainted by fraud.” *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 435 (S.D.N.Y. 2001) (“*Mishkin*”). Where a customer undertakes no market risk and can claim entitlement to cash or securities only because of a broker’s fraud, no “customer” relief under SIPA is available. *See, e.g., In re New Times*, 371 F.3d at 88; *Mishkin*, 263 B.R. at 435.

SIPA’s goal of customer protection must be carried out consistent with the securities laws of which SIPA itself is a part. Except as otherwise provided in SIPA, the provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (“the 1934 Act”), apply as if SIPA were an amendment to, and a section of the 1934 Act. SIPA § 78bbb. Moreover, as explicitly provided in SIPA, while a primary function of SIPA is to protect investors, it also reinforces the broker-dealer’s financial responsibility requirements so that the securities laws are strengthened and not weakened. Thus, in *Mishkin*, the trustee sought to set aside stock trades which resulted from the broker’s fraud, and the appellants, themselves innocent customers, sought to enforce their legitimate expectations in those transactions. The District Court affirmed judgment in favor of the trustee, holding that the broker’s “deeds cannot be ignored in assessing whether Appellants are entitled to enforce the Challenged Trades.” *Mishkin*, 263 B.R. at 435.

In the present case, to require the Trustee to rely on the fictitious account statements would give credence to the backdated trades and fake profits that were

invented out of thin air by BLMIS in furtherance of its fraud. While a central goal of SIPA is to protect customers, the protection cannot be at the expense of undermining the securities laws. As a result, the Trustee cannot treat the transfers of fictitious profits—clear violations of the securities laws—as “new principal” worthy of protection from SIPC and a distribution from the fund of customer property.

Finally, the Appellants urge that the Court in the *Net Equity Decision* only considered the two methods of calculating net equity presented to it—the Net Investment Method and the Last Statement Method—expressly leaving open the possibility of another method of computing net equity. (Ryan Br. 4.) While the Appellants hope that this window means that this Court will consider *their* inter-account method, they ignore the *Net Equity Decision*’s strong language which soundly rejects a computation method based upon impossibly profitable entries on the bogus statements produced by Madoff in furtherance of his Ponzi scheme. As this Court held, “use of the Last Statement Method in this case would have been an impermissible means of calculating ‘net equity.’” *Net Equity Decision*, 654 F.3d at 240. The Inter-Account Method may not be the only means of calculating the net equity of inter-account transfers, but the Appellants have not suggested a permissible alternative. The Inter-Account Method is consistent with the *Net*

Equity Decision and is not a wrong or unlawful method; indeed, it is the most equitable.

III. THE *NET EQUITY DECISION* FORECLOSES THE APPELLANTS' OBJECTIONS

The Appellants, like thousands of other BLMIS customers, may be victims of the BLMIS Ponzi scheme. Like thousands of other BLMIS customers, they conducted their financial affairs as if they had the significant assets on their BLMIS account statements. Unlike thousands of other BLMIS customers, however, the Appellants ask the Trustee to create net equity where none exists, essentially asking the Trustee to pay them extra from the pool of customer property. The pool of customer property, however, is not unlimited, and allowing higher claims for the Appellants would only, once again, take funds that belong to other customers. “Any dollar paid to reimburse a fictitious profit,” even one transferred from one account to another, “is a dollar no longer available to pay claims for money actually invested.” *Net Equity Decision*, 654 F.3d at 241.

In their attempt to justify their position, the Appellants continue to raise arguments which were properly rejected by the District Court both below and in the *Antecedent Debt Decision*. Many of these arguments, as the Bankruptcy Court noted, are similar to the arguments rejected by this Court in the *Net Equity Decision*, because they essentially seek to apply the Last Statement Method to inter-account transfers and “turn[] Madoff’s fiction into a fact.” *Bankruptcy Inter-*

Account Decision, 522 B.R. at 53. This Court has held that the last customer statement is an inappropriate basis for determining net equity, *Net Equity Decision*, 654 F.3d at 240, and the Appellants have failed to present a compelling argument as to why impossible entries on prior statements should be any more probative.

The Appellants' arguments are primarily based upon three incorrect assumptions. First, the Appellants assume that the Inter-Account Method is an avoidance of the inter-account transfers. To the contrary, as discussed in greater detail below, the calculation of net equity is not an avoidance action but a valuation which does not present the same burdens and disruptions as an action to avoid and claw-back or recover a transfer. *Inter-Account Decision*, 2016 WL 183492, at *12–13 (“Although net equity calculations and avoidance actions are related at a general level—in the context of an insolvent broker-dealer, each aims to facilitate the return of customer property to customers—they are governed by separate statutes situated within different titles of the United States Code, and they operate in distinct ways.”)

Second, the Appellants assume that the inter-account transfers involved a transfer of actual cash. To the contrary, the inter-account transfers were fictitious entries on fictitious statements; unlike cash deposits and withdrawals, they entail the transfer of fabricated profits. When a transferor's principal was exhausted, no actual cash was transferred. *Inter-Account Transfer Decision*, 2016 WL 183492, at

*9 (“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.”)

Third, the Appellants assume that the Inter-Account Method, by ignoring the book entry value of the transfers on the account statements, is violating SIPA’s requirement that a trustee determine net equity based upon the debtor’s books and records. To the contrary, in applying the Inter-Account Method, the Trustee is relying upon the only accurate books and records that BLMIS had: the actual cash deposits and withdrawals. *Net Equity Decision*, 654 F.3d at 232 (“Thus, the customer statements reflected unvarying investor success; but the only accurate entries reflected the customers’ cash deposits and withdrawals.”) While correcting these assumptions largely disposes of the Appellants’ arguments, their specific objections are discussed below.

A. The Inter-Account Method Does Not Violate the Two Year Statute of Limitations for Fraudulent Transfer Actions or Due Process

Appellants argue that when the Trustee limits the net equity value of an inter-account transfer to the amount of net equity in the transferor account, he is effectively avoiding the transfer, thereby violating the two year statutory reach-back period for avoidance actions for inter-account transfers made prior to December 2006. See 11 U.S.C. §§ 548(a)(1)(A), 546(e). This argument was

rejected by the Bankruptcy Court and twice by the District Court, below and in the *Antecedent Debt Decision*. The Inter-Account Method, instead, recognizes the same distinction between valuation of transfers and avoidance and recovery of transfers that the *Net Equity Decision* recognized.

In order to implement the *Net Equity Decision*, the Trustee must adjust the value of an account's net equity based upon transfers out of the account over the life of the account. As noted by the District Court,

[T]he Second Circuit's approval of the Net Investment Method in the *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. Such reductions are part and parcel of the Net Investment Method, which nets all deposits and withdrawals over the life of a BLMIS account.

Inter-Account Decision, 2016 WL 183492, at *12. Consider the following example: a customer has \$3 million in his BLMIS account, as reflected on his account statements, having invested \$1 million in principal. Prior to the two-year reach-back period, this customer withdraws \$2 million. Later, within the reach-back period, the customer deposits an additional \$1 million in principal. As of the filing date for the SIPA liquidation, his account statement says that he has over \$2 million, but his net equity, according to the Net Investment Method, is \$0, with \$2 million in deposits and \$2 million in withdrawals. Even though the Trustee cannot avoid the customer's withdrawal of his principal and \$1 million in fictitious profits,

the withdrawal gives him a negative net equity of \$1 million which cancels out the subsequent deposit of that amount.

The courts below explained that the relevant question here is not about disturbing or avoiding a transfer, but about determining the value of what was transferred. *Inter-Account Decision*, 2016 WL 183492, at *12–13. For this reason, the Inter-Account Method does not implicate the statutory reach-back period. By giving credit only to the transfers of principal and refusing to give credit for the transfers of fictitious profits, the Trustee is simply determining Appellants' claims consistent with SIPA. Valuing a claim under SIPA, or refusing to give credit for a claim is not the same as avoiding a transfer under the Bankruptcy Code, and thus is not subject to the Bankruptcy Code's statute of limitations.

The District Court's holding in the *Antecedent Debt Decision* is instructive. There, the District Court considered whether the Trustee could avoid withdrawals of fictitious profits in light of an asserted defense that the transfer had been provided "for value" on account of antecedent debt. In determining value to the estate, the District Court held that "only a defendant's investment of principal may count as 'value' with respect to the customer property estate for purposes of section 548(c)." *Antecedent Debt Decision*, 499 B.R. at 424 (S.D.N.Y. 2013). The defendants argued that to the extent that the Trustee reduced the value of their

principal by withdrawals that occurred prior to the reach-back period, he was circumventing the statute of limitations.

The District Court rejected this argument, explaining that the computation of the “value” defense under the fraudulent transfer laws has no reach-back period. The Trustee must look to the true “value” of the transfer—i.e., whether the defendant had provided corresponding value with a deposit, or whether that value had been eroded with prior withdrawals—regardless of how far back those deposits and withdrawals took place. *Antecedent Debt Decision*, 499 B.R. at 427. “The concept of harm or benefit [i.e., valuation] to the estate is separate from the concept of the reach-back period, which merely serves to allow finality to ancient transactions.” *Id.*

The Defendants in the *Antecedent Debt Decision* also argued, as here, that the account statement value of inter-account transfers prior to the reach-back period should be treated as principal (and thus provide value to the estate), because the Trustee could no longer avoid them. The District Court rejected this argument, adopting, in effect, the Inter-Account Method:

Although defendants contend that the Trustee’s method elevates form over substance, the true substance of transfers of fictitious profits from one account to another remains the same: 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. . . . In other words, no new value was created by moving these funds between different accounts.

Antecedent Debt Decision, 499 B.R. at 428–29. Likewise, here, the issue of the proper amount to credit the Appellants—the amount of value they provided to the estate—has no statutory look back period.

In response, the Appellants present a hypothetical in two scenarios, each using a different method of transfer, in an attempt to equate the transfer of fictitious profits with the deposit of new principal. (*See, e.g.*, Zraick Br. at 15–20.) Under Scenario 1, Customer A transfers fictitious profits to the checking account of Customer B. Here, Customer B has title to the money and, if she redeposits it in her own account at BLMIS, she receives full credit for the deposit as if the funds were principal. Under Scenario 2, on the other hand, Customer A effects an inter-account transfer between Customer A’s BLMIS account and Customer B’s BLMIS Account. Under the Inter-Account Method, Customer B would receive credit for the transfer only to the extent that Customer A had principal in her account.

Appellants incorrectly argue that there should be no difference in the outcome between Scenario 1 and Scenario 2. The scenarios, however, are very different. Under Scenario 1, in order for BLMIS to withdraw fictitious profits from Customer A’s account and write a check or wire funds to Customer B, BLMIS takes cash belonging to other customers and gives it to Customer B. Customer A has made a withdrawal of real cash, albeit constituting fictitious profits.

In contrast, under Scenario 2, no such withdrawal or monetization occurs. Because no profits exist to transfer, the transfer on paper only, between BLMIS accounts, does not monetize the sum. The non-existent nature of the property does not change when “transferred” between or among BLMIS accounts. Customer B will not be entitled to the amount “transferred” from another BLMIS account within BLMIS because the transfer is comprised of fictitious profits. If Customer B makes a withdrawal of the amount, BLMIS will take cash belonging to other customers and give it to Customer B. In that instance, the corresponding debit to Customer B’s BLMIS account, upon the withdrawal by Customer B from his account, must be a reduction or offset against any deposits of real cash in Customer B’s BLMIS account.

Furthermore, the facts in Scenario 1 rely on hypotheticals: a financial institution conducting real financial transactions (deposits and withdrawals on separate and real checking accounts), none of which happened in the transactions at issue here in BLMIS. Rather, the scenarios presented by the Appellants show how the determination of Customer A and Customer B’s net equities changes in each of the two scenarios. In both cases, only one customer – either Customer A or Customer B – effectively receives credit for the deposits as principal, and only one customer bears the consequences of a withdrawal and the avoidance action by the Trustee. When viewed from the perspective of other customers who have yet to

receive back their principal, Appellants' arguments about fairness, or the absence thereof, fail.

Importantly, the BLMIS Ponzi scheme, like any Ponzi scheme, survives when customers do not withdraw their money. "Madoff's scheme collapsed when the flow of new investments could no longer support the payments required on earlier invested funds." *Net Equity Decision*, 654 F.3d at 232. When a customer withdraws money from its BLMIS account, even if the money will be re-deposited in a few days, BLMIS must produce real cash by taking it from new investors. An inter-account transfer, on the other hand, is merely a book entry on fictitious account statements which does not entail the movement of any real cash within the BLMIS slush fund. An inter-account transfer continues the illusion of profitability without risking the perpetuation of the scheme.

Finally, Appellants also argue that the Trustee's method violates their due process rights for the same reason. As the Bankruptcy Court stated, "[t]his contention elevates a faulty statutory argument to the level of an equally faulty Constitutional claim" See *Bankruptcy Inter-Account Decision*, 522 B.R. at 52, n.8. Their due process rights have not been violated because their property is not the subject of an avoidance and recovery action. In any event, to the extent that Appellants argue that their due process rights require an opportunity to present

objections (Ryan Br. 34), that requirement has been met with the briefings, hearings, and appeals at hand.

B. The Calculation of Net Equity Does Not Violate Public Policy in Favor of Finality in Business Transactions

Relatedly, Appellants argue that public policy favors finality in transactions, and as such, the Appellants should receive credit for transfers of fictitious profits. The Bankruptcy Court and the District Court rejected this argument for many of the same reasons discussed above: “[t]he Inter-Account Method does not void any transaction, or implicate the finality concerns of doing so.” *Inter-Account Decision*, 2016 WL 183492, at *17. The law of gifts, state law property rights, and other laws that the Appellants cite for finality of transactions are inapplicable to claim determinations in a SIPA liquidation. The calculation of net equity for an inter-account transfer does not concern whether transfers were authorized as between two account holders, or whether one of those account holders has a right to unwind the transaction.

Certainly, Appellants make no allegation that the transfers were unauthorized or unilaterally made on the BLMIS’s initiative. Rather, the transfers were initiated by the Appellants, who are responsible for the repercussions. Cases cited by Appellants, such as *Banque Worms v. BankAmerica International*, 928 F.2d 538 (2d Cir. 1991), are distinguishable. In *Banque Worms*, for example, this Court applied New York law on restitution (which is not applicable here) to

determine whether a mistaken payment should be returned. *Id.* at 541. Here, the Trustee is not asking the Appellants to return a mistaken payment but is only determining the value of their claims.

For many of the Appellants, the inter-account transfers purported to be gifts, inheritances, or other transfers between and among related individuals. If the transfer between Customer A and Customer B was the result of an arm's-length transaction, the validity of the transfer likely could not be called into question. In fact, the New York Court of Appeals has decided at least one analogous situation in *Simkin v. Blank*, 19 N.Y.3d 46 (N.Y. Ct. App. 2012) (holding that a divorce agreement that was finalized before the Madoff fraud was revealed could not be unwound on the doctrine of "mutual mistake" even though one party received the BLMIS account in the settlement and thus bore the losses alone). But whether Customer B provided consideration for the transfer, and was owed the amount transferred to him, is a matter for resolution between the two customers and has no impact on the calculation of his or her net equity. Indeed, the Trustee cannot make such value determinations based upon BLMIS books and records, as required of him by SIPA. *Cf. Inter-Account Decision*, 2016 WL 183492, at *26 ("The value of an inter-account transfer from a shared account is properly determined by the net deposits and withdrawals of the customer's account unless the individual investors in the shared account can establish separate customer status.")

While the District Court did not find any conflict with the law regarding finality, it noted that, if a conflict existed, “SIPA’s system for distributing customer property would take precedence” as a federal law. *Inter-Account Decision*, 2016 WL 183492, at *18. Notably, when viewed as a matter of federal law, the desire for finality in a transaction, reflected in the Bankruptcy Code’s time limitations for avoidance and recovery, *see, e.g.*, 11 U.S.C. § 548(a)(1), is not present in SIPA for the calculation of a customer’s net equity. “Avoidance actions are far more disruptive. Rather than determine the customer’s share of an as-yet undistributed fund, such actions seek to reclaim money from present holders. There is, therefore, a greater finality interest in limiting a Trustee’s ability to undo transfers and claw back money that an individual received from a failed broker-dealer.” *Inter-Account Decision*, 2016 WL 183492, at *13.

In contrast, SIPA requires the Trustee to determine net equity claims “insofar as such obligations are ascertainable from the books and records of the debtor,” without consideration to the age of the books and records. SIPA § 78fff-2(b); *Inter-Account Decision*, 2016 WL 183492, at *12. This Court recognized this distinction when it held that Bankruptcy Code section 546(e) limited the Trustee’s avoidance and recovery actions even while the *Net Equity Decision* allowed him to base valuations on transfers that occurred many years ago. *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC)*, 773 F.3d 411, 423 (2d

Cir. 2014). While the Bankruptcy Code “statutes of limitations reflect that, at a certain point, the need for finality is paramount even in light of countervailing equity considerations,” the calculation of a customer’s net equity must be “harmonize[d] . . . with the SIPA statutory framework as a whole,” and thus is not limited by the separate and distinct limitations in the Bankruptcy Code. *Id.* (citing the *Net Equity Decision*, 654 F.2d at 237).

C. Book Entries on Account Statements Do Not Create State Law Obligations Which Must Be Satisfied As Customer Claims

The Appellants also argue that state law creates an entitlement to the full value of the inter-account transfer. This Court, however, has already implicitly rejected that argument when it rejected the Last Statement Method in this case. The Appellants have not articulated why they are entitled to the full-face value of an inter-account transfer which contains fictitious profits but not the full-face value of fictitious securities in their account. In other words, if the Appellants believe that the book entry of a cash transfer gives them a state-law security entitlement to the full value of that cash, why would the book entry of the purchase of securities not give them a state-law security entitlement to the full value of the securities? The answer, as stated in the *Net Equity Decision*, is that, in both cases, “notwithstanding the BLMIS customer statements, there were no securities purchased and *there were no proceeds* from the money entrusted to Madoff for the

purpose of making investments.” *Net Equity Decision*, 654 F.3d at 240 (emphasis added).

SIPA does not protect against all forms of fraud, so it does not protect the fraudulent value of a transfer. As Judge Rakoff explained, “To allow defendants, who have no net equity claims, to retain profits paid out of customer property on the ground that their withdrawals satisfied creditor claims under state law would conflict with the priority system established under SIPA by equating net equity and general creditor claims.” *Antecedent Debt Decision*, 499 B.R. at 423. Similarly, when considering whether SIPA’s implementing rules giving customers a securities claim upon receipt of a “written confirmation,” see SIPC Series 500 Rules, 17 C.F.R. §§ 300.501(b)(1), 300.502(a)(1), this Court noted that “[t]he regulation does not, however, mandate that this ‘written confirmation’ form the basis for calculating a customer’s ‘net equity.’” *Net Equity Decision*, 654 F.3d at 236.

D. The Inter-Account Method Does Not Combine Accounts

Finally, Appellants argue that by treating the accounts of transferors and transferees separately for determination of net equity, the Trustee has combined separate customer accounts in violation of SIPC’s Series 100 Rules, 17 C.F.R. §§ 300.100–300.105. To the contrary, the Trustee’s determination of claims under the

Inter-Account Method honors the distinction between separate accounts and adheres to the Series 100 Rules.

SIPA section 78fff-3, which provides for SIPC advances to the Trustee for the benefit of customers up to statutory limits, states that “a customer who holds accounts with the debtor in separate capacities shall be deemed to be a different customer in each capacity.” SIPA § 78fff-3(a)(2). The SIPC Series 100 Rules specify how accounts of separate customers are identified. Under SIPC Rule 104, 17 C.F.R. §300.104, for example, a trust account created under a valid written trust instrument is deemed to be held by a customer in a separate capacity from, for example, an account held by the trustee or trust beneficiary as an individual. Thus, the trust account has its own net equity calculation and would be eligible for the maximum amount of SIPC protection separate from any other account held in a separate capacity.

In determining Appellants’ claims, as with all BLMIS claimants, the Trustee treated each account held in a different capacity separately in accordance with the SIPC Series 100 Rules. Transfers of principal away from each of the transferor accounts were deposited into the transferee accounts, which, for most if not all of the Appellants, were accounts of separate customers. The nature of the fictitious profits did not change, and such fictitious profits were not transformed into principal, by the transfer of the fictitious profits into a separate account. Both prior

and subsequent to the inter-account transfer, the Trustee calculated the net equity for the transferor and transferee account separately, and each account could be eligible for a SIPC advance of up to \$500,000.

In contrast, if the Trustee did combine accounts, he would have credited all deposits and debited all withdrawals from the two accounts together, determined the net equity for both accounts as if they were one, and then, if the combined accounts had a positive net equity, provided the SIPA protection of up to \$500,000 only once to the new combined account, not to the accounts separately. The Trustee did not do that here, correctly implementing the SIPC Series 100 Rules.

The facts presented by Mr. Sagor's appeal illustrate this point.² Mr. Sagor was a beneficiary of a defined benefit pension plan (the "Pension Plan" or "Plan") which held an account at BLMIS ("Account One"). (Sagor Br. 5.) He alleges he deposited \$175,000 into the Pension Plan. (*Id.*) In 2001, Mr. Sagor opened up an individual retirement account at BLMIS ("Account Two"), transferring his share of the Pension Plan in Account One to Account Two, totaling \$656,429 after fictitious gains. (*Id.* at 6–8.) Unfortunately, as with numerous other claimants who were the beneficiaries of an accountholder (rather than the accountholder itself), other Pension Plan participants had already made withdrawals from the Plan, taking the principal the Pension Plan had invested in Account One and leaving

² Mr. Sagor's argument is addressed in Section IV, *infra*.

only fictitious profits and a negative equity. (*Id.* at 11–12.) Thus, Mr. Sagor’s transfer of \$656,429 consisted entirely of fictitious profits, and Account Two received no net equity credit for the transfer. (*Id.*) Mr. Sagor subsequently deposited real cash totaling \$184,067.82 into Account Two and withdrew nothing, and the Trustee allowed his claim for this amount. (*Id.*) If the Trustee improperly combined accounts, he would calculate the net equity of Account One and Account Two together, and Mr. Sagor’s additional deposits into Account Two would be swallowed up by the negative net equity in Account One. In that scenario, Mr. Sagor would have no claim at all. Instead, the Trustee honored the distinction between the accounts and allowed Mr. Sagor’s claim.

IV. UNDER SIPA, NET EQUITY MUST BE CALCULATED BY ACCOUNT, NOT BY INDIVIDUAL BENEFICIARIES

Distinct from the other Appellants, Elliot Sagor does not dispute the Inter-Account Method. Instead, Mr. Sagor raises the issue of whether the calculation of net equity from a transferor account—and thus the credit received by a transferee—should be done based upon individual contributions to the accountholder rather than for the accountholder as a whole. Referring to the facts recounted in the preceding subsection, Mr. Sagor does not argue that he should get the full value of his inter-account transfers from Account One, totaling \$656,429. Instead, he believes that, when the net equity of the inter-account transfer from Account One to Account Two is calculated, he should receive credit for his

personal principal in the Pension Plan, allegedly \$175,000 with no withdrawals. Because Account One had a negative net equity at the time of the transfer, however, Mr. Sagor did not receive any credit.

To be a “customer” under SIPA, an investor must have “a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person,” including “any person who has deposited cash with the debtor for the purpose of purchasing securities.” SIPA § 7811(2). SIPA “contemplates that a person may be a ‘customer’ with respect to some of his claims for cash or shares, but not with respect to others. *F.O. Baroff*, 497 F.2d at 282 n.2. Mr. Sagor admits that he was not a “customer” in Account One. (Sagor Br. 8.) He admits that if he remained in Account One, he would have no claim. (*Id.* at 23, n.16.) Mr. Sagor, however, argues that, for equitable considerations, his individual net equity for the inter-account transfer from Account One should be calculated independently from the other Plan participants in Account One because he subsequently opened a separate account which does qualify him as a customer.

In Mr. Sagor’s case, the transferor Account One was held in the name of a defined benefit Pension Plan which had multiple individuals or beneficiaries. The net equity of Account One was affected by withdrawals by other individuals or beneficiaries—that is, all principal was withdrawn leaving only fictitious profits.

The Trustee, however, must calculate the net equity for these types of accounts as a whole and not according to individual stakeholders' net deposits and withdrawals *within* that one account. See *Bankruptcy Inter-Account Decision*, 522 B.R. at 61 (citing *Kruse v. Sec. Inv'r Prot. Corp. (In re BLMIS)*, 708 F.3d 422, 426–27 (2d Cir. 2013 (“*Kruse*”)) (holding that investors in feeder funds that invested with BLMIS were not customers of BLMIS and were not entitled to their own net equity calculation or protection). The individual beneficiaries such as Mr. Sagor are not customers entitled to their own net equity calculations. Indeed, in most cases dealing with plan beneficiaries such as Mr. Sagor, the Trustee could not even calculate the individual's principal in the plan based upon BLMIS's books and records, which would only reflect the Pension Plan's deposits and withdrawals.

Here, based upon BLMIS's books and records, Mr. Sagor did not deposit \$175,000 into Account One. Instead, Mr. Sagor allegedly deposited \$175,000 into the Pension Plan. The money then became property of the Pension Plan, and the Plan deposited \$175,000 into Account One. *Cf. Kruse*, 708 F.3d at 427 (“[T]he limited partnership interests sold by the Feeder Funds to investors . . . did not confer an ownership interest in money that the Feeder Funds ultimately invested in BLMIS. Thus, regardless of their intent, appellants never entrusted their cash or securities to BLMIS and, thus, fail to satisfy this critical aspect of the customer definition.” (internal citations and quotation marks omitted)). In other words,

Mr. Sagor did not have any principal in Account One which could be the subject of a separate customer net equity calculation. “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 [Pension Plan].” *Inter-Account Decision*, 2016 WL 183492, at *25.

Mr. Sagor’s appeal to the equities is unavailing. As this Court held,

[A]rguments based solely on the equities are not, standing alone, persuasive. If equity were the criterion, most customers and creditors of [the debtor] would be entitled to reimbursement for their losses. Experience, on the other hand, counsels that they will have to settle for much less. SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customer.

Packer Wilbur, 498 F.2d at 983. Regardless, the equities of the case as a whole do not favor Mr. Sagor. As with the other Appellants, the inter-account transfer to Account Two consisted of fictitious profits. Allowing Mr. Sagor’s claim based upon fictitious, manipulated profits would harm the many other BLMIS customers who have not yet recovered their principal. *Inter-Account Decision*, 2016 WL 183492, at *24. Moreover, the Pension Plan had already recovered its principal and withdrawn fictitious profits at the time of the inter-account transfer to Mr. Sagor, so the recognition of the transfer as positive net equity places the Plan itself in a better position than justified by its investment. *Id.* at 26.

Mr. Sagor also argues that his approach will not have a large impact upon the claims process. As the District Court points out, however, Mr. Sagor underestimates the potential impact of his arguments. *Id.* His approach would greatly benefit those claimants who only had indirect relationships with BLMIS through their interests in feeder funds or partnerships, such as those in *Kruse*. Like him, these claimants would like to have their individual interests in BLMIS accounts calculated separately and to be eligible for an advance of \$500,000. Even if Mr. Sagor's approach would affect only his claim, the Trustee cannot accept it as it is contrary to SIPA's requirements, and "[c]reating an exception to the overall Net Investment Method to bolster Sagor's recovery would work a detriment on BLMIS's net-loser customers." *Id.* at *24.

Finally, Mr. Sagor's recourse is against the other beneficiaries of the Pension Plan in Account One who withdrew its entire principal, leaving Account One, and Mr. Sagor in Account Two as to the inter-account transfer, with only fictitious profits. If the transferee did not receive the full benefit of his bargain with the transferor, the transferee might have a rescission claim, or some other claim, against the transferor. But the question of whether the transferee provided value for the transfer, and the consequences thereof, ultimately is irrelevant to the calculation of a BLMIS customer accountholder's net equity under SIPA.

CONCLUSION

For all of the aforementioned reasons, the District Court Opinion should be affirmed.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

This brief complies with Fed. R. App. P. 32(a)(7)(B) because the brief contains 11,180 words, excluding the parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word in 14-point Times New Roman font.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Nathanael S. Kelley, hereby certify that on August 22, 2016, I caused true and correct copies of the foregoing Brief of Intervenor Securities Investor Protection Corporation to be served upon those parties who receive electronic service through ECF in the within appeal.

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