19-429-bk(L),

19-443-bk(CON), 19-501-bk(CON), 19-510-bk(CON)

United States Court of Appeals
FOR THE
Second Circuit

In Re: BERNARD L. MADOFF INVESTMENT SECURITIES LLC,

IRVING H. PICARD, Trustee for the Liquidation of BERNARD L. MADOFF INVESTMENT SECURITIES LLC, and BERNARD L. MADOFF,

Plaintiff-Appellee,

– v –

EMANUEL GETTINGER, SOUTH FERRY BUILDING COMPANY, ABRAHAM WOLFSON and ZEV WOLFSON, UNITED CONGREGATIONS MESORA, SOUTH FERRY #2 LP, TURTLE CAY PARTNERS, COLDBROOK ASSOCIATES PARTNERSHIP, individually and in its capacity as general partner of Turtle Cay Partners,

(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

OF COUNSEL:

KEVIN H. BELL
Senior Associate General Counsel
For Dispute Resolution

NATHANAEL S. KELLEY
Associate General Counsel

KENNETH J. CAPUTO
General Counsel

SECURITIES INVESTOR PROTECTION CORPORATION
1667 K Street, N.W., Suite 1000
Washington, D.C. 20006
Telephone: (202) 371-8300

Date: September 3, 2019
Washington, D.C.

THE ESTATE OF MARIANNE LOWREY, JAMES LOWREY, capacity as general partner of Turtle Cay Partners, capacity as personal rep of Estate Of Marianne Lowrey, capacity as trustee for Marianne B. Lowrey Trust, & capacity as Successor Partner Coldbrook Associates Partner, AARON WOLFSON,

Defendants-Appellants,

ABRAHAM ADEFF, GOLDIE APPELGRAD, SIMCHA APPELGRAD, DAVID G. AVIV, B.F.& W. REALTY COMPANY, MIRIAM BEREN, ZELDA ELBAUM, RAZEL FASKOWITZ, ROSLYN GETTINGER, MORRIS GOLDSTEIN, SAMUEL GOLDSTEIN, MR. ISRAEL GROSSMAN, KALMAN HALPERN, ZEVI HARRIS, JOSEPH KATZ, BESSIE KAUFMAN, DAVID KAUFMAN, A. TRUST, A.N. TRUST, A.O.N. TRUST, AA. TRUST, AARON TRUST, ABRAHAM TRUST, ABRAHAM N. TRUST, AL. TRUST, ALISA TRUST,

Defendants,

SECURITIES INVESTOR PROTECTION CORPORATION,

Intervenor.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1(a) of the Federal Rules of Appellate Procedure, Intervenor Securities Investor Protection Corporation certifies that it has no parent corporation, and there is no publicly held corporation owning 10% or more of stock in the Securities Investor Protection Corporation.

TABLE OF CONTENTS

PAGE

STATEMENT OF THE ISSUES 1

COUNTER-STATEMENT OF THE CASE 2

SUMMARY OF THE ARGUMENT 2

ARGUMENT 3

I. THE TRUSTEE CAN AVOID AND RECOVER THE TRANSFERS 3

A. The Trustee's *Prima Facie* Case for Avoidance of Actual Fraudulent Transfers 4

B. Appellants Cannot Retain the Transfers Under § 548(c) 4

1. Transfers of Fictitious Profits in a Ponzi Scheme Cannot Be for Value 5

2. The Limitation of Value to the Principal Deposited in a Ponzi Scheme Comports with SIPA 9

3. Securities Laws Do Not Recognize Value in Fictitious Profits 13

a) No Value Established Under Federal Securities Laws 14

b) No Value Established Under State Securities Laws 17

c) The Appellants Cannot Support Their Value Claims Through Inapposite Case Law 21

CONCLUSION 23

CERTIFICATE OF COMPLIANCE 24

TABLE OF AUTHORITIES

CASES: **PAGE**

In re Adler, Coleman Clearing Corp., 263 B.R. 406 (Bankr. S.D.N.Y. 2001) 11

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972)............................. 15–16

Amer. Sur. Co. of N.Y. v. Sampsell, 327 U.S. 269 (1946)...20

Balaber-Strauss v. Sixty-Five Brokers (In re Churchill Mortg. Inv. Corp.),
256 B.R. 664 (Bankr. S.D.N.Y. 2000)..8

Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp., LLC), 362 B.R. 624 (Bankr. S.D.N.Y. 2007)...........................5, 8

In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011),
cert. dismissed, 132 S. Ct. 2712, *and cert. denied*,
132 S. Ct. 24 and 133 S. Ct. 25 (2012) 7, 9–11, 14, 16–18

In re Bevill, Bresler & Schulman, Inc., 59 B.R. 353 (D.N.J.),
appeal dismissed, 802 F.2d 445 (3d Cir. 1986) 20

Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC), 439 B.R. 284 (S.D.N.Y. 2010)..5, 8

Donell v. Kowell, 533 F.3d 762 (9th Cir.), *cert. den.*, 555 U.S. 1047 (2008) 8

Dusek v. JPMorgan Chase & Co., 132 F. Supp. 3d 1330 (M.D. Fla. 2015),
aff'd, 832 F.3d 1243 (11th Cir. 2016)...17

Ferris, Baker Watts, Inc. v. Stephenson (In re MJK Clearing Inc.),
286 B.R. 109 (Bankr. D. Minn. 2002), *aff'd,* Civ No. 02-4775 RHK,
2003 WL 1824937 (D. Minn. Apr. 7, 2003), *aff'd*, 371 F.3d 397
(8th Cir. 2004) 7

Hecht v. Andover Assocs. Mgmt. Corp., 114 A.D.3d 638 (N.Y. App. Div. 2014)................17

J.I. Case v. Borak, 377 U.S. 426 (1964)...15

Janvey v. Brown, 767 F.3d 430 (5th Cir. 2014) 14

TABLE OF AUTHORITIES (cont.)

CASES: **PAGE**

In re Lehman Bros. Holdings Inc., No. 17CV3762, 2018 WL 1441407, (S.D.N.Y. Mar. 22, 2018) 20

Mackey v. Lanier Collection Agency & Service, 486 U.S. 825 (1988) 22

Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981) 15

Panos v. Island Gem Enters., Ltd., N.V., 880 F. Supp. 169 (S.D.N.Y. 1995) 15

Picard v. Greiff (In re Madoff Sec.), 476 B.R. 715 (S.D.N.Y. 2012) 8, 12, 16

Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC), 773 F.3d 411 (2d Cir. 2014) 21–22

Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54 (2d Cir. 2013) 3

Picard v. Lowrey (In re Bernard L. Madoff), 596 B.R. 451 (S.D.N.Y. 2019) 4, 22

Picard v. Lowrey (In re Bernard L. Madoff Inv. Sec. LLC), Adv. Proc. No. 10-04387 (SMB), 2018 WL 1442312 (Bankr. S.D.N.Y. March 22, 2018) 13

Rosenman Family, LLC v. Picard, 395 F. App'x 766 (2d Cir. 2010) 3

Sagor v. Picard (In re Bernard L. Madoff Inv. Sec., LLC), 697 F. App'x 708 (2d Cir. 2017) 10, 14, 20

Scholes v. Lehmann, 56 F.3d 750 (7th Cir.), *cert. denied sub nom. African Enter., Inc. v. Scholes*, 516 U.S. 1028 (1995) 6, 8

Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 499 B.R. 416 (S.D.N.Y. 2013) 11, 13

Sender v. Buchanan (*In re Hedged-Invs. Assocs.*), 84 F.3d 1286 (10th Cir. 1996) 8

In re Sharp Int'l Corp., 403 F.3d 43 (2d Cir. 2005) 5

TABLE OF AUTHORITIES
(cont.)

CASES: **PAGE**

Silverman v. Cullin, 633 F. App'x 16 (2d Cir. 2016)...8

Trustees of Upstate New York Engineers Pension Fund v. Ivy Asset Mgmt.,
843 F.3d 561 (2d Cir. 2016) 8, 16–17

United States v. McCombs, 30 F.3d 310 (2d Cir. 1994) 5

United States v. Jicarilla Apache Nation, 564 U.S. 162 (2011) 22

Visconsi v. Lehman Bros., Inc., 244 F. App'x 708 (6th Cir. 2007) 15

Williams v. FDIC (In re Positive Health Mgmt.), 769 F.3d 899 (5th Cir. 2014) 6

STATUTES AND RULES:

New York Uniform Commercial Code Law §

8-501, cmt. 5..18
8-502, cmt. 4..19
8-503...18
8-503, cmt 1...20
8-503(b)...19
8-504...18
8-505...18
8-506...18
8-507...18
8-508...18

Rules and Regulations Under the Securities Exchange Act of 1934, 17 C.F.R. §

240.15c3-3...6–7, 12

TABLE OF AUTHORITIES
(cont.)

STATUTES AND RULES: **PAGE**

Securities Investor Protection Act, as amended, 15 U.S.C. §

78eee(d) ... 1
78fff-1(a) ... 12
78fff-2(b) ... 4, 9–11
78fff-2(c)(1) ... 4, 11
78fff-2(c)(3) ... 4, 12, 22
78*lll*(4) ... 4
78*lll*(11) ... 11

Securities Exchange Act of 1934 §

28(a) ... 14–15, 17
28(a)(2) ... 13
29(b) ... 13, 21

United States Bankruptcy Code, 11 U.S.C. §

546(e) ... 21–22
548(a)(1)(A) ... 4–5, 11, 21–22
548(c) ... 4–6, 9, 11, 21–22

PUBLICATIONS:

5 Collier on Bankruptcy ¶ 548.04[3][c]
(Richard Levin & Henry J. Sommer eds.,16th ed.) ... 6

This appeal arises in the context of a liquidation proceeding under the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa–78*lll* ("SIPA").[1] Under SIPA § 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 Opening Brief of Defendants-Appellants Emanuel Gettinger, *et al.*

STATEMENT OF THE ISSUES

SIPC joins in the issues as presented by Plaintiff-Appellee Irving H. Picard, as trustee ("Trustee") for the consolidated liquidation of Bernard L. Madoff Investment Securities ("BLMIS") and Bernard L. Madoff ("Madoff"), and writes separately to address the following issue:

Where investors deposited funds with a securities brokerage firm that used the funds, not to invest in securities, but rather to fuel a Ponzi scheme, and where those investors subsequently withdrew from the scheme their original principal deposits, plus fictitious profits stolen from other investors, do the securities laws and the Bankruptcy Code[2] recognize any obligations satisfied by, or value exchanged for, the transfer of fictitious profits?

SIPC respectfully submits that the answer is no.

[1] For convenience, future references to provisions of SIPA shall omit "15 U.S.C."

[2] 11 U.S.C. §§ 101 *et seq*. For convenience, future references to provisions of the Bankruptcy Code shall omit "11 U.S.C."

COUNTER-STATEMENT OF THE CASE

SIPC adopts the Counter-Statement of the Case set forth by the Trustee.

SUMMARY OF THE ARGUMENT

The Defendants-Appellants (hereinafter "Appellants") are investors in the BLMIS Ponzi scheme who withdrew more money than they deposited. They seek to retain these so-called "profits" to the detriment of all other customers who fell victim to the massive Ponzi scheme. But as this Court has previously held in the SIPA liquidation of BLMIS, customers who withdrew more from their accounts than they deposited have no "net equity" claims under SIPA. Thus, to allow the Appellants to retain "profits" and benefit from the scheme would conflict with the priority system of investor protection established under SIPA to treat all customers equitably.

In a Ponzi scheme, as a matter of law, the transfer of funds by the perpetrator demonstrates actual intent to defraud creditors, because such transfers extend the scheme and deepen investor losses. Where there is actual intent to defraud creditors, trustees may avoid the transfer, except if a good-faith transferee can demonstrate that it took such transfer for "value." The Appellants argue that under the Bankruptcy Code and state and federal securities laws, the account statements provided to them by BLMIS, setting forth their purported securities positions, gave them claims which were satisfied by the transfers, thereby providing "value" under the Bankruptcy Code and preventing the trustee from recovering such transfers. But, as the Bankruptcy Court stated in its Report and Recommendation to the District Court, and as the

District Court below correctly held in its decision, in the context of a SIPA liquidation resulting from a Ponzi scheme, a transferee *cannot* provide "value" for the receipt of fictitious profits.

As this Court has previously held, what a transferee is entitled to receive in this SIPA liquidation of BLMIS is the net amount of the transferee's deposits minus any withdrawals. As applied in this case, that means that the Appellants have already received the return of all they deposited and thus have no "net equity" claims under SIPA. To allow the Appellants, who have no net equity claims, to retain the fictitious "profits" works to the detriment of all other customers of BLMIS and runs counter to the program of investor protection established under SIPA. In other words, any withdrawals in excess of deposits are not for "value," and pursuant to the Bankruptcy Code, the Trustee may avoid such excess withdrawals if made within the statute of limitations period.

ARGUMENT

I. THE TRUSTEE CAN AVOID AND RECOVER THE TRANSFERS

As this Court has previously stated, "SIPA liquidations involve two kinds of claimants: customers and general unsecured creditors." *Rosenman Family, LLC v. Picard*, 395 F. App'x 766, 768 (2d Cir. 2010). Customers of the failed firm have priority over all other creditors, and they alone are entitled to share in a fund of "customer property." *Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC),* 721 F.3d 54, 71 (2d Cir. 2013) ("SIPA creates a fund of customer property that is separate

from the debtor estate and that has priority over other creditors' claims, and authorizes the trustee to ratably distribute those funds based on customers' net equity."); *see also* SIPA §§ 78fff-2(b) and (c)(1); 78*lll*(4).

Consistent with SIPA's goal of maintaining a fund of customer property for the satisfaction of customer claims, a SIPA trustee may bring avoidance actions for the recovery of customer property when the pool of customer property is insufficient to make every customer whole. SIPA § 78fff-2(c)(3). Recovery under SIPA is dependent only upon the voidability of the transfer under the Bankruptcy Code.

A. The Trustee's *Prima Facie* Case for Avoidance of Actual Fraudulent Transfers

There is no dispute that the Trustee has established a *prima facie* claim under § 548(a)(1)(A) to avoid an actual fraudulent transfer. As the District Court below stated, "The Trustee further asserted, and defendants do not dispute, that BLMIS had transferred the funds at issue 'with the actual intent to hinder, delay, or defraud some or all of [BLMIS's] then existing and/or future creditors." *Picard v. Lowrey (In re Bernard L. Madoff)*, 596 B.R. 451, 458 (S.D.N.Y. 2019) ("*District Court Decision*"). Thus, the pertinent issue is whether the Appellants can properly avail themselves of the affirmative defense under § 548(c) to retain the transferred funds.

B. Appellants Cannot Retain the Transfers Under § 548(c)

Appellants argue that they are entitled to retain the transfers of fictitious profits under Bankruptcy Code § 548(c). To satisfy this affirmative defense, "[a] transferee

bears the burden of proving that it took: (1) 'for value . . . to the extent that [it] gave value' to the debtor in exchange for such transfer and (2) 'in good faith.'" *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC)*, 439 B.R. 284, 308 (S.D.N.Y. 2010) (quoting § 548(c)). The Appellants' good faith is not at issue in this case.

Section 548(c) does not prohibit avoidance; indeed, the entire amount of any transfer meeting the elements of § 548(a)(1)(A) is avoidable regardless of the value the debtor received. *See Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp., LLC)*, 362 B.R. 624, 629 (Bankr. S.D.N.Y. 2007); *cf. In re Sharp Int'l Corp.*, 403 F.3d 43, 56 (2d Cir. 2005) ("[W]here actual intent to defraud creditors is proven, the conveyance will be set aside regardless of the adequacy of consideration given." (quoting *United States v. McCombs,* 30 F.3d 310, 328 (2d Cir. 1994)) (analyzing the N.Y. Uniform Fraudulent Conveyance Act)). Rather, § 548(c) allows a transferee to retain a voidable transfer to the extent of value provided.

Thus, the pertinent issue here is whether, in the context of a Ponzi scheme that results in a liquidation proceeding under SIPA, the Appellants can prove that they provided "value" to the debtor. SIPC respectfully submits that they cannot.

1. Transfers of Fictitious Profits in a Ponzi Scheme Cannot Be for Value

Courts uniformly hold that the transfer of fictitious profits in furtherance of a Ponzi scheme cannot be for value. "A profit is not offset by anything; it is the

residuum of income that remains when costs are netted against revenues. The paying out of profits to [a transferee] not offset by further investments by him conferred no benefit on [Ponzi scheme entities] but merely depleted their resources faster." *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir.), *cert. denied sub nom. African Enter., Inc. v. Scholes*, 516 U.S. 1028 (1995); *see also Williams v. FDIC (In re Positive Health Mgmt.)*, 769 F.3d 899, 909 (5th Cir. 2014) (recognizing that the phrase "to the extent" in § 548(c) mandates a "netting" of transfers, and "in the Ponzi context, dollar-for-dollar netting is both practicable and important in balancing the interests of creditors with the interests of transferees"); *see generally* 5 COLLIER ON BANKRUPTCY ¶ 548.04[3][c] (Richard Levin & Henry J. Sommer eds., 16th ed.) ("Amounts received in excess of the amounts investments [sic], however, are uniformly held to be subject to recovery.").

In *Scholes v. Lehmann*, Judge Posner explained the rationale for this approach in a Ponzi scheme, even when an investor had some legitimate trades in his account:

> The money used for the trades came from investors gulled by fraudulent representations. [The transferee] was one of those investors, and it may seem "only fair" that he should be entitled to the profits on trades made with his money. That would be true as between him and [the Ponzi scheme perpetrator]. It is not true as between him and either the creditors of or the other investors in the [Ponzi scheme]. He should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud.

Scholes, 56 F.3d at 757.

This rationale is especially persuasive in a SIPA liquidation proceeding like the present case. Pursuant to both SIPA and SEC Rule 15c3-3 (the "Customer

Protection Rule")[3], customer property is to be held in custody for all customers and must be segregated from the broker's own funds. SIPA is designed to work in tandem with the Customer Protection Rule to "ensure that customer property in a failed brokerage firm is available to satisfy the claims of customers . . . ." *Ferris, Baker Watts, Inc. v. Stephenson (In re MJK Clearing Inc.)*, 286 B.R. 109, 129–32 (Bankr. D. Minn. 2002), *aff'd,* Civ No. 02-4775 RHK, 2003 WL 1824937 (D. Minn. Apr. 7, 2003), *aff'd*, 371 F.3d 397 (8th Cir. 2004).

In the Ponzi scheme perpetrated by Madoff, there was no legitimate activity in the customers' accounts. As this Court has held, "the customer statements were after-the-fact constructs . . . , were rigged . . . , and were arbitrarily and unequally distributed among customers." *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 238 (2d Cir. 2011) (the "*Net Equity Decision*"), *cert. dismissed*, 132 S. Ct. 2712, *and cert. denied*, 132 S. Ct. 24 and 133 S. Ct. 25 (2012). Thus, any calculation of fictitious "profit" must net the amount of money deposited against the amount withdrawn over the life of an account. Withdrawals in excess of principal are the fictitious "profits" for which even innocent investors cannot provide value. In order to determine the amount of fictitious "profits" which may be avoided, courts apply a two-step process:

> First, amounts transferred by Madoff Securities to a given defendant at any time are netted against the amounts invested by that defendant in

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[3] 17 C.F.R. § 240.15c3-3 (requiring, in relevant part, a broker-dealer to (1) take and maintain possession and control of customers' fully paid and excess margin securities, and (2) establish a special reserve bank account for customer cash for the exclusive benefit of customers).

> Madoff Securities at any time. Second, if the amount transferred to the defendant exceeds the amount invested, the Trustee may recover these net profits from that defendant to the extent that such monies were transferred to that defendant in the two years prior to Madoff Securities' filing for bankruptcy.

Picard v. Greiff (In re Madoff Sec.), 476 B.R. 715, 729 (S.D.N.Y. 2012) ("*Greiff*") (adopting *Donell v. Kowell*, 533 F.3d 762, 771–72 (9th Cir.), *cert. den.*, 555 U.S. 1047 (2008)); *see also Scholes*, 56 F.3d at 757–58 (explaining that, in a Ponzi scheme, "[a]ll [the investor] is being asked to do is to return the net profits of his investment – the difference between what he put in at the beginning and what he had at the end."); *Sender v. Buchanan* (*In re Hedged-Invs. Assocs.*), 84 F.3d 1286, 1290 (10th Cir. 1996) (finding investor had no claim beyond original investment); *Christian Bros. High Sch. Endowment*, 439 B.R. at 337 ("[T]o the extent that investors have received payments in excess of the amounts they have invested, those payments are voidable as fraudulent transfers." (quoting *Bayou Superfund, LLC*, 362 B.R. at 636)).

As this Court has recognized, the use of the Ponzi scheme presumption to calculate a value defense in fraudulent transfer actions has gained wide acceptance in the federal courts, including in the district and bankruptcy courts below. *Silverman v. Cullin*, 633 F. App'x 16, 17 (2d Cir. 2016); *see also Trustees of Upstate New York Engineers Pension Fund v. Ivy Asset Mgmt.*, 843 F.3d 561, 567 (2d Cir. 2016) (quoting with approval *Balaber-Strauss v. Sixty-Five Brokers (In re Churchill Mortg. Inv. Corp.)*, 256 B.R. 664, 682 (Bankr. S.D.N.Y. 2000) for "the universally-accepted rule that investors may retain distributions from an entity engaged in a Ponzi scheme to the extent of their

investments, while distributions exceeding their investments constitute fraudulent conveyances").

The Appellants further argue that the courts below inappropriately used SIPA's net equity calculation to determine the value they provided in exchange for withdrawals. Appellants' Br. at 58. That argument is a red herring. The courts' application of the Net Investment Method, as approved in the *Net Equity Decision*, 654 F.3d 229 (*i.e.*, a calculation of the principal deposited minus withdrawals), is consistent with the method of calculating value under § 548(c) for transfers received in furtherance of a Ponzi scheme and is uniformly applied by courts. In other words, the use by the District Court below of the Net Investment Method to determine the Appellants' value defense in this case is not evidence of SIPA superseding the Bankruptcy Code but rather the consistent and proper application of the Bankruptcy Code in a SIPA liquidation. Simply put, SIPA requires a trustee to discharge the debtor's obligations to customers, SIPA § 78fff-2(b), and under SIPA and applicable securities laws, in a Ponzi scheme case, any attempt by a claimant to claim or keep more than the principal invested harms all other customer claimants.

2. The Limitation of Value to the Principal Deposited in a Ponzi Scheme Comports with SIPA

The Appellants argue that the transfers to them by BLMIS merely satisfied obligations owed to them by BLMIS, and since these obligations constituted valid and enforceable antecedent debts, they provided value. But this argument ignores the

context of this case – a SIPA liquidation brought on by a Ponzi scheme – and prior decisions of this Court that apply SIPA to that context. These cases hold that obligations representing fictitious profits do not have any enforceable value. For example, as set forth in this Court's *Net Equity Decision*,

> a SIPA trustee's obligation to reimburse customers based on "net equity" must be considered together with SIPA's requirement that the Trustee discharge "*obligations of the debtor* to a customer relating to, or net equity claims based upon . . . securities . . . insofar as 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 at 237 (citing SIPA 78fff-2(b)) (emphasis added). The Court then approved the use of the Net Investment Method to value those obligations. *Id.* at 238–39. And, as the Court further made clear, "the BLMIS customer statements reflect impossible transactions and the Trustee is not obligated to step into the shoes of the defrauder or treat the customer statements as reflections of reality." *Id.* at 242.

The Court reiterated this view in *Sagor v. Picard (In re Bernard L. Madoff Inv. Sec., LLC)*, 697 F. App'x 708 (2d Cir. 2017), where it stated, "[w]e continue to refuse, however, to 'treat[ ] fictitious and arbitrarily assigned paper profits as real' and to give 'legal effect to Madoff's machinations.'" *Id.* at 713 (quoting the *Net Equity Decision*, 654 F.3d at 235). This Court also noted the harmony of the Net Investment Method with the law of actual fraudulent transfers: "in the context of *this* Ponzi scheme[,] the Net Investment Method is . . . more harmonious with provisions of the Bankruptcy

Code that allow a trustee to avoid transfers made with the intent to defraud, *see* 11 U.S.C. § 548(a)(1)(A), and 'avoid[s] placing some claims unfairly ahead of others.'" *Net Equity Decision*, 654 F.3d at 242, n.10 (quoting *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406, 463 (Bankr. S.D.N.Y. 2001)).

Under SIPA, the calculation of a customer's "net equity" is, in essence, a determination of the obligations the debtor owes its customers. *See* SIPA § 78fff-2(b) ("[T]he trustee shall promptly discharge . . . all *obligations of the debtor to a customer* relating to, or net equity claims based upon, securities or cash . . . ." (emphasis added)). Upon the commencement of a SIPA liquidation proceeding of a debtor firm, obligations of the firm must be discharged in accordance with SIPA. That is, customers share, *pro rata*, in customer property based upon their net equity – the calculus of the obligations owed to them. *See* SIPA §§ 78fff-2(c)(1) and 78*lll*(11).

In a prior decision addressing the value of antecedent debt in the BLMIS Ponzi scheme, the District Court found that equating "value" under § 548(c) with the net amount invested to be consistent with SIPA's policy of treating "each investor equitably by providing for recovery of customer property and pro rata distributions based on each customer's net equity claim, rather than merely letting those who came out ahead to retain the amounts obtained." *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 499 B.R. 416, 425 (S.D.N.Y. 2013) (the "*Antecedent Debt Decision*"). Thus, limiting the value defense to the extent of net principal deposited by the investor in a Ponzi scheme properly comports with the treatment of claims under SIPA.

The Appellants seek to counter this by arguing that no "customer property" estate exists under SIPA until the commencement of the liquidation proceeding, and thus the transfers here, made prior to the commencement of the case, cannot become part of the debtor's "customer property." Appellants' Br. at 56–60. But this argument ignores the clear language of SIPA. As the District Court noted in *Greiff*, SIPA explicitly empowers the Trustee to avoid and recover transfers based upon the designation of, and claims to, customer property which, under the Appellants' reading, would not exist until the filing date. As explained by Judge Rakoff:

> SIPA empowers a trustee to avoid transfers to recover customer property in order to pay priority claims. 15 U.S.C. § 78fff-2(c)(3). Had Congress wanted to give the Trustee only a general power to avoid fraudulent transfers, it could have relied on § 78fff-1(a), which amply serves that purpose. Instead, it explicitly empowered the Trustee to recover fraudulent transfers in order to satisfy claims that would not exist before the commencement of a SIPA proceeding. Defendants' narrow temporal argument disconnects the powers conferred by § 78fff-2(c)(3) from the purpose specifically described, effectively rendering § 78fff-2(c)(3) a superfluous reiteration of the general grant of power conferred by § 78fff-1(a).

Greiff, 476 B.R. at 728, n.11.

In this case, when customers entrusted their funds to BLMIS, the Customer Protection Rule obligated the firm to preserve those funds in a separate reserve account. 17 C.F.R. § 240.15c3-3. The securities laws barred BLMIS from using those funds for its own ends or to pay its own debts. Thus, any transfers from BLMIS in excess of principal were paid for only through the prohibited use of other customers' funds. As the Bankruptcy Court below stated,

> Even if BLMIS owed obligations to the Defendants, the [other] customers did not, and the use of their property to pay fictitious profits was not supported by value. The Two Year Transfers did not satisfy an antecedent debt owed by the customers or provide value to the other customers – to the contrary, they denuded the customer property.

Picard v. Lowrey (In re Bernard L. Madoff Inv. Sec. LLC), Adv. Proc. No. 10-04387 (SMB), 2018 WL 1442312, at *12 (Bankr. S.D.N.Y. March 22, 2018) (citations omitted).

As the District Court held in the *Antecedent Debt Decision,* any claims the Appellants have based on state and federal laws that purport to allow them to retain fictitious "profits" cannot be supported, because those claims cause harm to the customer property estate, and thus to all other customers. That is because those claims are not "net equity" claims, and the retention by the Appellants of such funds would "allow[ ] such claims to be drawn out of the customer property estate [and] would violate SIPA." 499 B.R. at 424.

3. Securities Laws Do Not Recognize <u>Value in Fictitious Profits</u>

The Appellants attempt to distinguish the voluminous case law adverse to their interests regarding fraudulent transfers in furtherance of a Ponzi scheme by asserting that such cases involved equity investors with rescission claims, not broker-dealer customers with contract rights. In contrast with these equity-based Ponzi scheme investors, the Appellants argue that they, as securities-based Ponzi scheme investors, "invoked their substantive federal rights under Section 28(a)(2), 15 U.S.C. § 78bb(a)(2), and Section 29(b), 15 U.S.C. § 78cc(b), of the 1934 Act to enforce their

state law contractual rights notwithstanding Madoff Securities' fraud." Appellants' Br. at 6. This is a distinction without a difference. A contractual relationship between the Ponzi scheme perpetrator and the investor does not create value where none exists, and cases involving Ponzi schemes have allowed the recovery of fictitious profits whether or not the investor had a contractual claim to those fictitious profits. *See, e.g.*, *Janvey v. Brown*, 767 F.3d 430, 441 (5th Cir. 2014) (holding that defendants who purchased CDs as part of a Ponzi scheme did not have a contractual right to retain fictitious profits in excess of their undertaking).

This Court has already rejected the use of federal securities laws to support the fictitious values represented on BLMIS account statements: "[T]here can be no legal reliance on any of BLMIS's statements with regard to funds in any of the BLMIS accounts because doing so 'would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations.'" *Sagor*, 697 F. App'x at 712 (quoting *Net Equity Decision*, 654 F.3d at 235). The Appellants' contract rights under the securities laws do not entitle them to fictitious profits stolen from other customers.

a) <u>No Value Established Under Federal Securities Laws</u>

Whatever the validity of Appellants' securities law causes of action, they only entitle Appellants to their out-of-pocket losses – *i.e.*, their principal – and do not allow them to retain fictitious profits. As held by the Supreme Court, "the correct measure of damages under § 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the

fair value of all that the [victim] received and the fair value of what he would have received had there been no fraudulent conduct . . . ." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972). The Supreme Court has further noted that courts must "be alert to provide such remedies as are necessary to make effective the congressional purpose." *J.I. Case v. Borak*, 377 U.S. 426, 433 (1964).

As the District Court has held, "in most cases brought under the 1934 Act defrauded buyers are restricted to recovering solely their out-of-pocket losses." *Panos v. Island Gem Enters., Ltd., N.V.*, 880 F. Supp. 169, 176 (S.D.N.Y. 1995). Taking the same approach as in the protection offered under SIPA, courts recognize the risk that investors undertake when investing in the securities market. "Reluctant to place the risk of investment on defendants' shoulders, even given their intentional misconduct, courts have opted for the more reliable out-of-pocket measure as their primary remuneration vehicle." *Id.*

A case cited by the Appellants, *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981) confirms this approach to actual damages. In that case, this Court, construing a prior version of Securities Exchange Act § 28(a), held that the plaintiffs were limited to actual damages, "whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard." *Id.* at 111. But the Court emphasized that "giving the plaintiff benefit-of-the-bargain damages is appropriate only when they can be established with reasonable certainty." *Id.* at 114; *cf. Visconsi v. Lehman Bros., Inc.*, 244 F. App'x 708, 713 (6th Cir. 2007)

(allowing defrauded investors to recover the amounts shown on fraudulent statements where "the fictitious statements issued by Lehman . . . were designed to track Plaintiffs' funds as if they had been properly invested . . . .").

Here, in this Ponzi scheme, there was no certainty whatsoever. As this Court held, the value reflected on customer statements were "after-the-fact constructs that were based on stock movements that had already taken place, [and] were rigged to reflect a steady and upward trajectory in good times and bad . . . ." *Net Equity Decision*, 654 F.3d at 238. Because BLMIS conducted an entirely fictitious Ponzi scheme, "what [the Appellants] would have received had there been no fraudulent conduct," *Affiliated Ute Citizens of Utah*, 406 U.S. at 155, is an unknown amount, impossible to quantify.

As the District Court stated, "Defendants have undoubtedly suffered harm as a result of investing with Madoff Securities, but they have not shown that this harm in any way corresponds to the amounts reflected on customer statements." *Greiff*, 476 B.R. at 726. In other words, "the Court has no reliable basis on which to determine how defendants would have benefited from their bargains with Madoff Securities." *Id.* at 725.

This approach is consistent with what this Court held when addressing claims of BLMIS victims against their investment managers. In *Trustees of Upstate New York Engineers Pension Fund v. Ivy Asset Mgmt.*, the Court held that "[t]he loss of an opportunity to lay hands on funds belonging to others is not a legally cognizable

injury. . . . We therefore decline to measure loss based on the amount of other investors' money that the Plan could have withdrawn had it maximized its potential gains in Madoff's Ponzi scheme." 843 F.3d at 568 (citations omitted).

Accordingly, the Appellants' securities law claims would only recognize the same value established by the Trustee's Net Investment Method: the return of principal. Any other measure of value or damages, including the award of interest or speculation of what Appellants might have earned, would be inappropriate where such damages would necessarily come from other innocent investors. "The inequitable consequence of such a scheme would be that 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." *Net Equity Decision*, 654 F.3d at 238; *see also Dusek v. JPMorgan Chase & Co.*, 132 F. Supp. 3d 1330, 1353 (M.D. Fla. 2015) (stating that if investors "were able to recover the securities shown on their fictitious account statements, it would effectively legitimize Madoff's fraudulent scheme. Such a result would be inconsistent with the measure of damages set forth in Section 28(a) of the Exchange Act"), *aff'd*, 832 F.3d 1243 (11th Cir. 2016).

b) <u>No Value Established Under State Securities Laws</u>

State laws likewise recognize that Appellants are not entitled to retain fictitious profits, and they do not recognize value for fictitious securities. *See, e.g., Hecht v. Andover Assocs. Mgmt. Corp.*, 114 A.D.3d 638, 641 (N.Y. App. Div. 2014) ("It is

undisputed that the profits reported by Madoff were completely imaginary. The fictitious profits never existed and, thus, Andover did not suffer any loss with respect to the fictitious sum." (citation omitted)). Assuming *arguendo*, that the New York Uniform Commercial Code's provisions on security entitlements, N.Y. U.C.C. Law § 8-501 *et seq.*, apply in this SIPA liquidation, they actually support the Trustee's recovery of fictitious profits for ratable distribution to all customers.

To the extent that BLMIS's delivery of fictitious account statements to Appellants gave them security entitlements, such security entitlements do not establish value. *Cf. Net Equity Decision*, 654 F.3d at 236 ("[SIPA's implementing regulation] does not, however, mandate that this 'written confirmation' [of a securities transaction] form the basis for calculating a customer's 'net equity.'"). The U.C.C. commentary elucidates: "A security entitlement is the package of rights that a person has against the person's own intermediary with respect to the positions carried in the person's securities account." N.Y. U.C.C. Law § 8-501, cmt. 5 (McKinney). This package of rights is described in N.Y. U.C.C. Law §§ 8-503–8-508.

If Appellants had valid security entitlements, however, the U.C.C. is clear that a holder of a security entitlement to a limited or nonexistent asset cannot take priority over similarly situated holders. Instead, the U.C.C. states that holders of security entitlements must share in any value on a *pro rata* basis:

> An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary,

> without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.

N.Y. U.C.C. Law § 8-503(b) (McKinney). Thus, a securities entitlement is not ownership of a financial asset and does not establish any particular value for that entitlement.

BLMIS was operated as a Ponzi scheme with no securities trading to support the Appellants' or any other investors' account statements. Appellants' security entitlements thus only give them their *pro rata* share of a fiction – *i.e.*, nothing – and the entitlement has no value. As explained in the U.C.C. official commentary, while the U.C.C. protects security entitlements, if a securities intermediary does not have sufficient assets to satisfy security entitlement holders' positions, "the problem . . . is not that someone is trying to take away their entitlements, but that the entitlements are not worth what they thought." N.Y. U.C.C. Law § 8-502, cmt. 4 (McKinney).

Perhaps most importantly, the U.C.C. itself defers to SIPA in the event of a brokerage firm's liquidation. The official commentary to § 8-503 of the New York Uniform Commercial Code explains:

> Although this section describes the property interest of entitlement holders in the assets held by the intermediary, it does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings. *If the intermediary fails and its affairs are being administered in an insolvency proceeding, the applicable insolvency law governs how the various parties having claims against the firm are treated.* For example, the distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ("SIPA") provide that all customer property is distributed pro rata among all

> customers in proportion to the dollar value of their total positions, rather than dividing the property on an issue by issue basis.

N.Y. U.C.C. Law § 8-503 cmt. 1 (McKinney) (emphasis added); *see Sagor,* 697 F. App'x at 712–13; *see also 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."); *In re Bevill, Bresler & Schulman, Inc.*, 59 B.R. 353, 378 (D.N.J.), *appeal dismissed*, 802 F.2d 445 (3d Cir. 1986) (finding that state law that is inconsistent with SIPA is preempted).

Recently, in the liquidation of Lehman Brothers Inc., the District Court affirmed that SIPA extinguished the debtor's pre-liquidation U.C.C. obligations to transfer financial assets because "allowing the claims at issue here would be inconsistent with SIPA's provisions." *In re Lehman Bros. Holdings Inc.*, No. 17CV3762, 2018 WL 1441407, at *9 (S.D.N.Y. Mar. 22, 2018). Countering the claimants' argument in that case that the N.Y. U.C.C. afforded them certain rights to sustain their claims, the court held "when the insolvent broker-dealer can no longer perform its duties, SIPA displaces the UCC and defers to the Trustee's decisions in satisfying the unperformed duties of the broker-dealer." *Id.* at *8. Furthermore, "while the Bankruptcy Code provides for the allowance of general claims, it does so in a SIPA proceeding only to the extent that it does not undermine SIPA's remedial purposes and the Trustee's statutorily prescribed duties." *Id.* at *9.

c) The Appellants Cannot Support Their Value Claims Through Inapposite Case Law

The Appellants further argue that § 548(c) shields all securities account payments that fall within the safe harbor of § 546(e) – or, in other words, that a transfer that meets the criteria of § 546(e) necessarily conferred value. Appellants' Br. at 34. The Appellants rely primarily upon *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC)*, 773 F.3d 411 (2d Cir. 2014) ("*Fishman*"), which held that transfers from BLMIS to its investors fall under the § 546(e) safe harbor exception for avoidability for certain securities-related payments. *Fishman*, 773 F.3d at 414. Taking the argument a step further, the Appellants assert that under Section 29(b) of the 1934 Securities Exchange Act, they have the right to enforce their contracts against BLMIS and can retain the fictitious profits they received by virtue of those contracts. Appellants' Br. at 35.

The Appellants miss the point. The *Fishman* decision, § 546(e), and Section 29(b) do not relate to the issue of "value" in this case. In *Fishman* the Court found that the transferees had received settlement payments from BLMIS under securities contracts. However, the Court made clear that "§ 546(e) is expressly inapplicable to claims of actual fraud brought under § 548(a)(1)(A)." *Id.* at 416. Thus, the Appellants' attempt to conflate value under § 548(c) and § 546(e) is without merit, as it distorts both the statutes and *Fishman*. As the District Court below correctly held,

"[t]he two issues are distinct matters of statutory construction, and very different." *District Court Decision*, 596 B.R. at 467.

When a transfer meets the criteria of § 546(e), the Appellants' position would render superfluous both § 546(e)'s carve out for actions under § 548(a)(1)(A), and the value prong of § 548(c). Such an interpretation finds no support in law. *See United States v. Jicarilla Apache Nation*, 564 U.S. 162, 185 (2011) ("[W]e are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law." (quoting *Mackey v. Lanier Collection Agency & Service*, 486 U.S. 825, 837 (1988)).

Indeed, this result would be contrary to (1) SIPA, which expressly allows avoidance and recovery of customer property, *see* § 78fff-2(c)(3); (2) the Bankruptcy Code, which allows avoidance of actual fraudulent transfers of securities payments, *see* § 546(e); (3) the *Fishman* decision, which explicitly left claims for actually fraudulent transfers intact, *see Fishman*, 773 F.3d at 423, and (4) securities laws, which look at actual damages and do not value fictitious profits. *See discussion supra* at pp. 13–20. The Appellants' argument equating settlement payments under § 546(e) with value under § 548(c) must fail.

CONCLUSION

For the foregoing reasons, the Opinion and Order of the District Court should be affirmed.

Respectfully submitted,

s/ Kenneth J. Caputo
KENNETH J. CAPUTO
General Counsel

KEVIN H. BELL
Senior Associate General Counsel for
Dispute Resolution

NATHANAEL S. KELLEY
Associate General Counsel

SECURITIES INVESTOR
PROTECTION CORPORATION
1667 K St., NW, Suite 1000
Washington, D.C. 20006
Telephone: (202) 371-8300
E-mail: kcaputo@sipc.org
E-mail: kbell@sipc.org
E-mail: nkelley@sipc.org

CERTIFICATE OF COMPLIANCE

This brief complies with Fed. R. App. P. 32(a)(7)(B)(i), as modified by Second Circuit Local Rule 32.1(a)(4)(A), because the brief contains 5,922 words, excluding the parts exempted by Fed. R. App. P. 32(f).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5)(A) 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 Garamond font.

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Respectfully submitted,

SECURITIES INVESTOR PROTECTION CORPORATION

s/ Nathanael S. Kelley
NATHANAEL S. KELLEY

1667 K Street, N.W., Suite 1000
Washington, D.C. 20006
Telephone: (202) 371-8300