

**The Madoff Fraud: Unwinding a Ponzi Empire (Part 2)**  
**A Talk with David Sheehan**

**I. Net Equity**

- A. Securities Investor Protection Act of 1970 (SIPA) was enacted to protect the customer when a broker-dealer fails. The customer is entitled to cash and/or securities that were on deposit with the broker at the time the company failed.
- B. The trustee uses a net equity analysis to assess claims, excluding fictitious profits as well as debts owed to BLMIS in the form of fees.
  - 1. Net equity is the value of the assets minus any liabilities and debt obligations.
  - 2. The trustee analyzed BLMIS cash statements from 1981 to 2008, tracking the funds put in and taken out, to calculate each claimant's net equity.
  - 3. Each claimant's net equity is the difference between the initial investment and the amount disbursed to the individual during the course of investment.
- C. Net winners and net losers
  - 1. As of early 2015, there were over 16,000 claims and about a quarter to twenty percent of those claims were allowable claims.
    - a. Of those, only about half have been allowed and the others have been denied.
    - b. Customers who withdrew less money than their investments are "net losers." Those who withdrew more than their investment are "net winners."
    - c. Each allowed claimant is entitled to a pro rata share of the fund of customer property based on their net equity.
  - 2. Even though "net winners" withdrew more than their investment amounts, non-complicit "net winners" are still victims of the fraud.
    - a. There are many "net winners" who qualify for the Hardship Program. In such cases, the trustee evaluates individual circumstances and exercises discretion in not pursuing a return of those funds.
    - b. Among "net winners" are also charities that unwittingly withdrew fictitious profits.
      - i. For example, Hadassah, the Women's Zionist Organization of America, settled in the amount of \$45 million to be transferred to the trustee.
      - ii. Hadassah earned about \$97 million in profits over the course of the investment.

3. Some “net winners” challenged the use of the net equity calculations and argued for the use of BLMIS’ last cash statement in 2008. The Second Circuit upheld the trustee’s method of determining net equity.<sup>1</sup>
4. Second Circuit reaffirmed the net equity method in June 2017.<sup>2</sup>

## II. Bankruptcy Act and New York State Laws

### A. Good faith defendants

1. 11 U.S. Code §548(c)<sup>3</sup>: an individual who took a transfer or obligation for value and in good faith can retain that interest or enforce that obligation to the extent that they provided value in consideration for the transaction.
  - a. “Good faith” is a defense to fraudulent transfer actions.
  - b. The Bankruptcy Code does not define “good faith” as used in this section.
2. In a SIPA liquidation, the trustee must show that the defendant had actual knowledge of the fraud or was “willfully blind” to the fraud. *Securities Investor Protection Corporation (“SIPC”) v. Bernard L. Madoff Investment Securities LLC (“BLMIS”)*, No. 12 Misc. 115, 2014 WL 1651952 (S.D.N.Y. Apr. 27, 2014).

### B. Typically, a trustee may avoid any certain types of transfers depending on when the transfer occurred.

1. 15 U.S.C. 78fff-2(c)(3)<sup>4</sup>: the trustee may avoid a transfer to the same extent such transfer would be voidable under the Bankruptcy Code.
2. The trustee may avoid a transfer if made within 90 days before filing of the petition.<sup>5</sup>
  - a. A preference occurs when the debtor knows they are going out of business before others and begins selectively repaying some creditors over others.
  - b. Courts presumptively recognize this as an improper unequal payment.
3. If within a 1-year period from dissolution and the transferees are insiders. 11 U.S.C. §547(b)(4)(B).

<sup>1</sup> In re Bernard L. Madoff Inv. Sec. LLC, No. 10-2378-bk(L), slip op. (2d Cir. August 16, 2011): <http://caselaw.findlaw.com/us-2nd-circuit/1577617.html>

<sup>2</sup> Sagor et al v Picard, 2nd U.S. Circuit Court of Appeals, Nos. 16-413, 16-420, 16-423: <http://caselaw.findlaw.com/us-2nd-circuit/1862904.html>

<sup>3</sup> 11 U.S. Code §548(c): <https://www.law.cornell.edu/uscode/text/11/548>

<sup>4</sup> 15 U.S. Code § 78fff–2 - Special provisions of a liquidation proceeding: <https://www.law.cornell.edu/uscode/text/15/78fff-2>

<sup>5</sup> 11 U.S. Code §547(b): <https://www.law.cornell.edu/uscode/text/11/547>

4. If within a 2-year period from dissolution and is fraudulent conveyance. 11 U.S.C. §548.
- C. Application of the Bankruptcy Code and New York State laws
1. The Bankruptcy Code also adopts applicable state law. 11 U.S.C. §544.
  2. New York State law provides for recovery of transfers made within six years of the petition for certain frauds.<sup>6</sup>
  3. Against “innocent investor” defendants, however, avoidance of transfers is limited to a two-year clawback period. See *Picard v Ida Fishman Revocable Trust* (In re Bernard L Madoff Inv Sec LLC), 773 F.3d 411 (2d Cir. 2014).
    - a. § 546(e) is a safe harbor that protects customers who receive transfer from a broker that are “made in connection with a securities contract” or are “settlement payments.”
    - b. The Second Circuit found that the transfers qualified both as payments made in connection with securities contracts and as settlement payments, and therefore were not subject to avoidance.

### III. Common Law Claims

- A. *In pari delicto* (“in equal fault”)
1. Two or more people are all at fault or all guilty of a crime.
  2. The common law doctrine denies relief to both parties in civil actions if both parties are at fault.
  3. In 2016, Southern District of New York reaffirmed *in pari delicto* doctrine as a valid defense in bankruptcy proceedings. *Flaxer v. Gifford* (In re Lehr Construction Corp.), Case No. 1:15-cv-4350-GHW, 2016 WL 164616 (S.D.N.Y. Jan. 12, 2016)
- B. *Picard v. JPMorgan Chase Co.*, 721 F.3d 54 (2013)<sup>7</sup>
1. The trustee alleged several common law claims against JP Morgan Chase: that the bank failed to perform due diligence, ignored red flags, and was fully complicit in the Madoff fraud.
  2. The court ruled that Picard, as trustee, does not have standing to bring suit against JPMorgan on behalf of customer under *in pari delicto* and did not reach the merits of the claim.
  3. The ruling limits the trustee’s ability to collect from financial institutions and distribute funds to BLMIS victims.

<sup>6</sup> N.Y. CPLR §213: <http://codes.findlaw.com/ny/civil-practice-law-and-rules/cvp-sect-213.html>

<sup>7</sup> *Picard v. JPMorgan Chase Co.* (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54 (2013): [http://www.leagle.com/decision/In\\_FCO\\_20130620121/IN\\_RE\\_BERNARD\\_L\\_MADOFF\\_INV\\_SECURITIES\\_LLC](http://www.leagle.com/decision/In_FCO_20130620121/IN_RE_BERNARD_L_MADOFF_INV_SECURITIES_LLC).

#### IV. Ongoing Recoveries

- A. \$17.5 billion in actual losses, almost \$11.6 billion recovered as of June 2017.<sup>8</sup>
  - 1. Litigation outstanding with a value of roughly \$10 billion.
  - 2. Total value of allowed claims in mid 2017 was over \$15 billion.
- B. Aftermath
  - 1. Thus far, there have not been significant changes in the securities industry as a result of the Madoff Ponzi scheme that would indicate that frauds are a thing of the past.
  - 2. To prevent such frauds of massive scale and longevity, investors should strongly be encouraged to educate themselves. Likewise, investment vehicles should display more transparency.

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<sup>8</sup> The Madoff Recovery Initiative – recoveries information:  
<http://www.madofftrustee.com/recoveries-04.html>