



## Second Circuit Affirms Madoff Trustee's Use of "Net Investment Method" to Calculate Net Equity Under SIPA

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### INTRODUCTION

Yesterday, the Second Circuit ruled that the Trustee in the liquidation proceedings of Bernard L. Madoff Investment Securities LLC ("BLMIS") properly used the "Net Investment Method" to calculate "net equity" under the Securities Investor Protection Act ("SIPA"). As a result, BLMIS customers may seek recovery under SIPA based on amounts deposited minus amounts withdrawn rather than based on the market value of securities reflected on final BLMIS account statements.

### BACKGROUND

In *In re BLMIS, Inc.*, No. 10-2378 (2d Cir. Aug. 16, 2011), certain former BLMIS investors appealed an Order of the Bankruptcy Court approving the Trustee's method of calculating customers' "net equity" under SIPA. The issue before the Second Circuit was "whether the method [the Trustee] selected for carrying out his responsibilities under SIPA is legally sound under the language of the statute." The BLMIS Trustee argued that "net equity" should be determined by calculating customers' amounts deposited into a BLMIS account less amounts withdrawn (the "Net Investment Method").<sup>1</sup> The BLMIS claimants argued that "net equity" should be calculated according to the market value of securities reflected in customers' final account statements (the "Last Statement Method"). In affirming the Bankruptcy Court's order, the Second Circuit held that the Trustee's decision to use the Net Investment Method, rather than the Last Statement Method, to calculate "net equity" under SIPA was legally sound and better effectuated the purposes of SIPA.

SIPA provides protection for customers of a failed broker-dealer in liquidation. Specifically, SIPA establishes a "customer property fund," consisting of cash and securities "received or held by the [liquidating] broker-dealer on behalf of customers." Customers share from this fund pro rata according to their "net equity." SIPA defines "net equity" as "the dollar amount of the account or accounts... determined by – calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated... all securities positions of such customer... minus any indebtedness of such customer to the debtor on the filing date." 15 U.S.C. § 78ll(11).

The Bankruptcy Court ruled in favor of the Net Investment Method, holding that customers' "net equity" could not be based on their last statements from BLMIS because those statements

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<sup>1</sup> The Securities and Exchange Commission and the Securities Investor Protection Corporation filed Second Circuit briefs supporting the Trustee's use of the Net Investment Method.

were “entirely fictitious” and did not represent the actual “securities positions that could be liquidated.” The Bankruptcy Court emphasized that SIPA’s “net equity” definition must be read in light of another SIPA section, which states that a trustee must discharge net equity claims only “insofar as such obligations are (1) ascertainable from the books and records of the debtor or (2) are otherwise established to the satisfaction of the trustee.” 15 U.S.C. § 78fff-2(b)(2). The Bankruptcy Court reasoned that the Trustee could not discharge claims based on customers’ final account statements when BLMIS’s “books and records” revealed account statements to be illusory records of securities that were never “ordered, paid for or acquired.”

### SUMMARY OF DECISION

The Second Circuit affirmed the Bankruptcy Court, holding that the Net Investment Method better effectuated the two goals of SIPA: to protect investors and to protect the securities markets. The Court rejected the Last Statement Method since it “would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff’s machinations.” Moreover, the Court found that analyzing the definition of “net equity” under 15 U.S.C. § 78lll(11) in light of the SIPA section dealing with discharging obligations ascertainable from debtor’s books and records “accord[s] with our usual practice of examining the overall structure and operation of a statute.”

### IMPLICATIONS

The Second Circuit did not adopt the Net Investment Method as the proper calculation of “net equity” in all circumstances. Rather, the Second Circuit found that the appropriate calculation method depends on the “myriad circumstances that may arise in a SIPA liquidation” and “[d]iffering fact patterns will inevitably call for differing approaches to ascertaining the fairest method for approximating ‘net equity,’ as defined by SIPA.” Moreover, the Second Circuit noted that possible calculation methods need not be limited to only the Net Investment Method or the Last Statement Method. Finally, the Second Circuit declined to express a “view on whether the Net Investment Method should be adjusted to account for inflation or interest, an issue on which the bankruptcy court has not yet ruled.”

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