Commentary: To the Victims Go the Spoils

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We are all familiar with the plight of those who invested with Bernie Madoff. For some, the experience merely took them from the penthouse to a slightly smaller penthouse. Others found themselves in the poorhouse, or without a house at all. Regardless of their resulting economic circumstances, each swindled investor long ago asked two central questions: "Can I get my money back?" and, if so, "How much am I entitled to?"

The answer to the first question is relatively straightforward – the Securities Investor Protection Corporation, or SIPC, will pay at least a portion of the money back. In 1970, Congress passed the Securities Investor Protection Act, or SIPA, which created SIPC. SIPC's membership consists of most of the broker-dealers registered with the SEC. It operates as a non-governmental, nonprofit corporation that exists for the sole purpose of repaying investors in bankrupt or financially troubled brokerage firms. When a brokerage firm goes bankrupt or does not have sufficient funds pay out investors, SIPC steps in and repays each investor for the amount of their loss, up to a maximum of $500,000. Any investor that is not a broker, dealer or bank, and that does not have control of or significant equity in the failed firm is entitled to SIPC compensation. SIPC generates funds by assessing its members an annual fee, historically in the range of $150 per year.

The second question has stirred significant debate, and spawned a class action lawsuit to boot. Before determining how much money an investor is entitled to recover, SIPC must ascertain how much that investor actually lost. This begins with a determination of the investor's "net equity". SIPC has traditionally defined net equity as the value of the investor's assets held at the firm as reflected on their most recent account statement, less any money the investor owes to the firm. For example, I put $100,000 into an investment account in 1995 and withdrew an aggregate of $50,000 over time. Assume the value of that account today is $200,000 and that I owe nothing to the firm. My net equity would be $200,000. If the brokerage firm holding my account went bankrupt, I could collect that $200,000 from SIPC.

For the Madoff investors, the calculation of net equity works a little differently. Irving Picard, the trustee appointed by the court to administer SIPC claims by Madoff investors, is calculating net equity as the amount of an investor's original investment less the aggregate amount the investor withdrew over time. If my brokerage account described above were a Madoff account, SIPC would calculate

my net equity as my $100,000 original investment less the $50,000 I withdrew over time, or a total of $50,000.

Now consider that quite a few Madoff investors withdrew more money over time than they originally invested. Due to the fantastic returns reported by Madoff over the years, these investors believed that the value of their accounts increased exponentially. Despite significant withdrawals, many still had very healthy accounts on Madoff's books. Under the trustee's new definition of net equity, these investors made a net gain with Madoff and are therefore not entitled to SIPC compensation. The bad news for these investors does not end there. The trustee, using the new definition of net equity, is also seeking a "clawback" of any gains received by investors. Under New York law, the trustee can attempt to clawback funds received within the past six years. When all is said and done, some investors may not only have lost accounts they once thought held considerable value, they may also owe money to SIPC.

Not surprisingly, a group of investors has banded together to file a class action suit in the bankruptcy court handling the Madoff case. The suit seeks a judgment requiring the trustee to use SIPC's original definition of net equity, giving investors credit for the value of the assets reflected on their last Madoff account statement. Press releases from the lawyers handling the investors' case cite the dire straights of sick, elderly investors who lost their homes and their life savings with Madoff and now will be left out in the cold. The stories tug at our heartstrings, but the argument is not so one-sided.

Lest we forget, outside of investors' initial deposits, the money reported on Madoff's account statements never actually existed. Decades of market beating returns reported by Madoff were entirely fraudulent. The value of investors' accounts never really increased, meaning that those who withdrew more than they originally invested really just received money put in by other investors. Why should these investors get to keep their fraudulent gains while other Madoff victims struggle to get anything at all?

Mr. Picard has also argued that giving credence to the fictitious numbers reported by Madoff is akin to allowing Madoff to arbitrarily determine who gets paid and who does not. It seems unjust to allow Madoff to have any influence over the recovery from his crime. In addition, Mr. Picard has indicated that he won't seek to "clawback" funds from certain hardship cases, and will work with those people on an individual basis to determine the best course of action.

SIPC is also appealing to the court of public opinion, recently announcing that it has already committed advances to Madoff investors of more than $534 million. Since its inception in 1970, SIPC has handled 321 cases, and paid out a total of $520 million. The payout for the Madoff investors is likely to total more than 4.4 billion. SIPC's payout in this one case will likely be more than eight times the aggregate payout in SIPC's nearly 40 year history. SIPC has already committed to

spend more money than it has in its coffers, and the payout amount will likely continue to grow.

The Madoff investors counter SIPC's arguments with accusations of corporate greed by SIPC's member firms. If SIPC fees had been higher than a paltry $150 per firm, they argue, then SIPC would have more in the bank to help make the Madoff victims whole. Even now, SIPC member firms could offer more funding to help ease the burden. Instead, the investors believe, Picard and SIPC unilaterally altered the definition of net equity to protect the financial interests of SIPC's members.

At first, the emotional arguments made by the Madoff investors almost convinced me to take their side. Then, the trustee's logical and practical arguments nearly persuaded me to join SIPC's camp. In the end, however, I am a lawyer, and it is the investors' stronger legal argument that ultimately wins my heart.

Put simply, SIPA defines the term "net equity" as the difference between (i) the amount a troubled firm would have owed an investor if the investor's account had been liquidated and (ii) any unpaid fees and other amounts the investor owes to the firm. The statute indicates that an investor is entitled to credit for the asset value reflected on the last account statement. However, the legal analysis does not end with the statute. We must also look to case law to see how the courts interpret net equity.

The class action filed by the Madoff investors will be decided by the bankruptcy court in the Southern District of New York, meaning that precedent from the United States Court of Appeals for the Second Circuit, which covers New York, will apply.

In the controlling Second Circuit case on this issue, *In re: New Times Security Services, Inc.*, the court considered how to interpret net equity when the investors' account statements reflected securities that were never actually purchased. Similar to the Madoff fraud, the account statements for some *New Times* investors showed real securities that could have been purchased but just never were. The court found that these investors had a legitimate expectation that their account statements were correct. For these investors, the court ruled that net equity should be interpreted in the traditional sense, reflecting the amount shown on the each investor's last account statement.

The account statements of the other investors in the *New Times* case showed securities that were completely non-existent. They were not securities at all, just figments of the defendant's imagination. The court found that these investors did not have a legitimate expectation that their account statements were correct. These investors were subject to the "money in" versus "money out" interpretation of net equity that SIPC would like to use for the Madoff investors.

Applying the statutory law and the decision in the *New Times* case to the facts of the Madoff investors' case, I believe the investors should be credited with net equity based on the value of the assets reflected on their last account statements. I just don't think Mr. Picard and SIPC can make a strong enough legal argument to the contrary.

Every lawyer knows the judge's opinion is the only one that really matters. The hearing on this issue in the Madoff case is scheduled for February 2, 2010. Perhaps I will be surprised.