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**CLAWBACK CLAIMS AGAINST THE MADOFF INVESTORS-  
THE PROCESS, THE EXPOSURE, AND AVAILABLE DEFENSES**

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A major issue and concern for many *Madoff* investors - particularly long term *Madoff* investors - is the Trustee's expressed intention to bring "clawback" actions against investors for payments received by them from BLMIS, even those who received payments innocently and without any knowledge of the massive fraud being perpetrated.

The Trustee will rely on the Bankruptcy Code provisions allowing the debtor to avoid transfers which constitute fraudulent conveyances within the meaning of the Code. In that regard, the SIPA statute incorporates those provisions of the Code which are not "inconsistent" with the SIPA statute. The Trustee will argue that clawback claims are not "inconsistent with" SIPA and are thus available to him.

The *Madoff* proceeding is a SIPC liquidation. As such, it is not technically a bankruptcy proceeding. Thus, the power and authority to bring clawback claims against innocent *Madoff* investors - the very class of persons that SIPA is designed to protect - presents a threshold question concerning whether the existence of such a power is "inconsistent" with the SIPA statute (and therefore not incorporated into SIPA). However, for purposes of this outline, the Trustee's authority to bring such claims will be assumed for the sake of analysis.

## **The Process**

In a real sense, the first step in a potential clawback claim has already occurred for most investors - namely the issuance of the Trustee's determination letter (the "Determination Letter") with respect to an investor's filed SIPC claim. If the Determination Letter rejects an investor's SIPC claim, in whole or in part, the investor must file specific written objections to the Determination Letter in order to preserve the claim. The failure timely to do so will be deemed to constitute an agreement with the Determination Letter by the investor (at least for purposes of determining Net Equity). Therefore, if you have not yet received your Determination Letter, be aware that (i) you or your counsel must respond within the time period set forth in the letter if you wish to object to the determination, in whole or in part, and (ii) the objections should be comprehensive, raising all known legal and factual arguments.

The Trustee has rejected the "Last Statement Balance" approach to determining Net Equity, adopting instead his "cash in/cash out" Net Investment approach. Therefore, his Determination Letters will compute your Net Equity on that basis.

Moreover, Bankruptcy Court Judge Lifland has recently sustained the Trustee's methodology and rejected the Last Statement Balance methodology urged by investors. At the same time, however, in recognition of the complexity of the legal issue and its importance to the ongoing liquidation process, Judge Lifland has certified an immediate appeal of his decision (directly to the Second Circuit Court of Appeals) rather than the usual procedure of deferring all appeals until the completion of the litigation process. Thus, the federal Appellate Courts will have the final say on the Net Equity issues which are so crucial to so many aspects of the *Madoff*

liquidation. Hopefully, this direct appeal will expedite the process, result in a reversal of the Trustee's methodology, and wind up with a recognition that the Last Customer Statement amount should be used to determine Net Equity, as most consistent with the SIPA statute and the Congressional intent when it enacted SIPA.

Under the Trustee's method, many investors who thought they had substantial positive account balances with BLMIS based on their last account statement now find that they have little, if any, Net Equity or at least far less than they thought they had. To use the Trustee's terminology and classifications, many investors who have suffered staggering real world losses have now been labeled as "Net Winners" and, as a result, that investor will have a zero Net Equity according to the Trustee.<sup>1</sup>

If, and to the extent that, the Trustee's method results in an investor being classified as a "Net Winner", such an investor is a potential target for a clawback claim by the Trustee.<sup>2</sup> As a general proposition, if a particular investor is a "Net Loser"-i.e. someone who has a positive SIPC Net Equity- it is unlikely that the Trustee can or will be asserting any clawback claims against that investor (other than possibly Preference Claims which seeks to avoid transfers made by the Debtor made within the 90 day period immediately preceding the filing of the SIPC liquidation petition- See separate discussion below under the heading "Preference Claims and Defenses").

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<sup>1</sup> Moreover, other investors, although still Net Losers under the Trustee's methodology, will nevertheless have the amount of their Net Equity reduced by any withdrawals made from the account.

<sup>2</sup> The Trustee may also bring clawback claims against parties deemed to have received payments with actual knowledge of or who otherwise acted in a complicit manner with Madoff (See, e.g., the actions brought against Picower, Chais, Comad, etc.).

The next step in the Clawback process is likely to be a demand letter from the Trustee in which he asserts the clawback claim, invites the investor either to pay the claim promptly or, in the alternative, to contact the Trustee's office (by counsel or personally) with any questions and/or with a view toward resolution of the claim.

Assuming the claim remains unresolved, the Trustee may then serve and file a complaint against the individual investor and the matter will then proceed (in the Bankruptcy Court) in much the same manner as any other contested litigation. The investor's counsel would file an answer with various affirmative defenses (which simply means the legal and factual reasons why the clawback claim should be denied) and after discovery proceedings are conducted (subject to such limitations as the Court may impose), ultimately each separate complaint will "go to trial" in the bankruptcy court.

Under the Bankruptcy Code, the Trustee must file any clawback claims within two years of the SIPC petition filing so we must anticipate that the Trustee will proceed with at least the commencement of the claims within that two year period (or, alternatively, enter into an appropriate agreement with an investor's counsel to toll the statute of limitations while Judge Lifland's Net Equity decision is on appeal). Once the Trustee has timely commenced the action, the Trustee may agree to a stay of further proceedings while the appeal of Judge Lifland's decision is on appeal. The Courts can also impose such a stay given the overriding significance of the issues raised by the appeal.

According to public statements made by the Trustee and his representatives, the Trustee will be exercising discretion in connection with whom he elects to bring a clawback action against. Theoretically, at least, this should mean that not every investor who may have potential

clawback exposure will necessarily be sued. Therefore, it is essential to consider promptly all mitigating circumstances, personal, financial and otherwise, either for a possible presentation to the Trustee (to head off any potential action) or for use in defending against any action brought by the Trustee.

An investor is entitled to be represented by counsel at all stages of the proceeding, and many of you have already retained counsel, some almost from the inception of the SIPC filing. Given the complexity of the clawback issues, an investor faced with potential clawback exposure should consult with counsel as soon as possible to review his or her specific facts and circumstances. As discussed below, there are significant available defenses and offsets to a clawback claim but they must be timely and properly asserted. Decisions made (or the failure to act) at an early stage in the process may have a material impact on future proceedings, both positive and negative.

### **The Potential Clawback Claims**

Under the Bankruptcy Code, the Trustee may assert a variety of potential claims under different Code sections.

Under the fraudulent conveyance provisions of the Bankruptcy Code, there is a two-year statute of limitations on claims that can be asserted, which means that the Trustee can only challenge transfers made on or after December 11, 2006. Transfers prior to that date are not avoidable under the Bankruptcy Code provisions. These claims include transfers allegedly made with an actual intent to hinder, delay or defraud existing or future creditors and transfers which

are deemed to be constructively fraudulent (i.e., without actual fraudulent intent).<sup>3</sup>

Under a separate provision of the Code, the Trustee is also allowed to use any applicable State fraudulent conveyance statute which means that in the *Madoff* proceedings, the Trustee may assert claims based on New York's fraudulent conveyance statute (contained in New York's Debtor/Creditor law). The New York State statute has a longer (six year) statute of limitations but imposes different requirements that the Trustee must prove to establish a claim and provides additional affirmative defenses as well.

### **Preference Claims and Defenses**

Independent of the Fraudulent Conveyance provisions, the Bankruptcy Code has a separate provision allowing a Trustee to avoid transfers made within 90 days before the filing of the petition, at a time when the debtor was insolvent, for or an account of an antecedent debt owed by the debtor before such transfer which, in addition, results in the transferee receiving more than he or she would have received in a normal bankruptcy liquidation. This form of avoidance claim is referred to in the Code as a Preference.

A Preference Claim does not require a fraudulent intent on the part of the debtor or the transferee (actual or constructive). Preference Claims are generally regarded as easier for the Trustee to establish and somewhat more difficult to defend against than a fraudulent conveyance claim.<sup>4</sup> Essentially, the Trustee must establish the fact of the transfer within the Preference

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<sup>3</sup> It is significant to note that the intent is that of the Debtor, Madoff, not the transferee.

<sup>4</sup> For example, although the Preference sections require that the debtor be insolvent at the time of the transfer in question, the Preference section also provides that for purposes of Preference claims, "the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."

period and it is then generally up to an investor to show that an available defense precludes the avoidance and recovery of the transfer.

Nevertheless, an investor should be aware that the Statute contains a number of statutory defenses to a Preference Claim. Thus, by way of example, the Preference section prohibits a Trustee from avoiding even a transfer made within the 90 day period if:<sup>5</sup>

1. the transfer was intended by the parties to be a “contemporaneous exchange for new value given to the debtor” and in fact there is a “substantially contemporaneous exchange”; or
2. the transfer was “in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee”, *or* was made according to ordinary business terms; or
3. after the transfer, the transferee gave “new value” to or for the benefit of the debtor which is unsecured and for which the debtor did not make a subsequent unavaoidable transfer

A key question in a Preference action will be the concept of “new value”. Does it literally require a new payments from the investor at or subsequent to the transfer? Will a Court view the contemporaneous and subsequent credits to the investor’s account as “new value” within the meaning of the statutory defense? Given the preferred status of the investor class of creditors in a SIPC liquidation, is it clear what an investor would have received in a chapter 7 (straight bankruptcy) liquidation? These are simply examples, not an all inclusive list

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<sup>5</sup> These are some of the more relevant defenses but is not intended to be an all-inclusive list.

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In sum, even with respect to Preference claims, there are available defenses to explore and analyze. Many are fact specific and may, therefore, vary from investor to investor depending on individual circumstances. Thus, if you are, or may be, subject to a Preference Claim, you are well advised to consult with counsel promptly to review your actual exposure and to identify available relevant defenses.

### **Defending Against Clawback Claims**

There are significant legal and fact-based defenses available to an investor who is or may be the subject of a clawback claim or proceeding. These include (but are not limited to) defenses based on: the SIPA statute (and whether it permits Clawback Claims because the investors are the “protected class” under SIPA and to allow such actions against innocent investors would be “inconsistent” with the SIPA Statute); the applicable Statutes of Limitations (two years under the Code/six years on a NYS claim); demonstrating that an investor received the payments in question with actual good faith and lack of knowledge and also provided “value” to BLMIS in exchange for the transfer (which, includes the satisfaction of an antecedent [pre-existing] debt owed by BLMIS to the Debtor).<sup>6</sup>

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<sup>6</sup> It is important to note that the concept of what constitutes an antecedent debt is not the same as the definition of Net Equity. Thus, even if the Trustee’s “Net Investment” approach is ultimately sustained, in the context of a clawback claim, the amount owed by BLMIS to an investor may well be different -and higher- than the investor’s Net Equity amount.

It is beyond the scope of this outline to analyze in depth these various defenses or to attempt to discuss what specific facts and circumstances a particular defense will or will not apply. That requires an individual assessment of individual investor circumstances which will vary greatly from investor to investor. What is vitally important for each investor to know is that there *are* significant potential defenses available which each investor should review and discuss with his or her counsel. You cannot simply rely on “the other guy” making the fight for you. Bluntly, if the Trustee’s clawback efforts are simply ignored by an investor, instead of vigorously resisted, the result will be a self imposed capitulation and further victimization of that investor, which seems counter-productive in view of these available legal and fact-based defenses.