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United States Court of Appeals
for the
Second Circuit

In Re: BERNARD L. MADOFF INVESTMENT SECURITIES LLC,

Debtor.

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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CORPORATE DISCLOSURE STATEMENT

In accordance with Rule 26.1 of the Federal Rules of Appellate Procedure, Appellant Export Technicians Inc. states that it has no parent corporation and no publicly held corporation owns 10% or more of its stock.

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I. JURISDICTIONAL STATEMENT

Appellants The Aspen Company, Ann Denver, Norton Eisenberg, Export Technicians Inc., Stephen R. Goldenberg, Judith Rock Goldman, Albert J. Goldstein U/W FBO Ruth E. Goldstein, Jerry Guberman, Anita Karimian, Michael and Stacey Mathias, Martin Rappaport, Paul J. Robinson, Bernard Seldon, and Harold A. Thau, represented by Milberg LLP and Seeger Weiss LLP,¹ and Mary Albanese, the Brow Family Partnership, Allen Goldstein, Laurence Kaye, Suzanne Kaye, Rose Less, and Gordon Bennett, represented by Lax & Neville, LLP,² (collectively “Appellants”) submit this brief in support of their appeal from the March 8, 2010 Order (1) Upholding Trustee’s Determination Denying Customer Claims for Amounts Listed on Last Customer Statements; (2) Affirming Trustee’s Determination of Net Equity; and (3) Expunging Those Objections With Respect to the Determinations Relating to Net Equity (“Net Equity Order”) issued by the United States Bankruptcy Court for the Southern District of New York (“Bankruptcy Court”) (Hon. Burton R. Lifland) (SPA-60).³ The Bankruptcy Court

¹ The Appellants represented by Milberg LLP and Seeger Weiss LLP have been assigned docket number 10-2676, which has been consolidated under lead docket number 10-2378.

² The Appellants represented by Lax & Neville, LLP have been assigned docket number 10-2679, which has been consolidated under lead docket number 10-2378.

³ Citations to SPA-___ refer to the Special Appendix [Dkt. No. 171].

had jurisdiction over this Securities Investor Protection Act (“SIPA”) liquidation proceeding pursuant to Section 78eee(b)(4). § 78eee(b)(4).⁴

On March 8, 2010, the Bankruptcy Court certified the Net Equity Order for direct appeal to this Court. *See* Certification of Net Equity Order of March 8, 2010 for Immediate Appeal [Bankr. Dkt. No. 2022].⁵ Appellants filed their Notices of Appeal on March 19, 2010. *See* Notices of Appeal (A-III:671, A-III:698).⁶

On April 7, 2010, the Appellants, jointly with certain other parties, filed in this Court a Joint Petition for Permission to Appeal Under 28 U.S.C. § 158(d)(2). On June 16, 2010, the Court granted the petition. *See* Order, No. 10-974 [Dkt. No. 63]. Accordingly, this Court has subject matter jurisdiction over this appeal pursuant to 28 U.S.C. § 158(d)(2).

⁴ Unless otherwise noted, all citations herein to Section ___ or § ___ refer to the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa, *et seq.*

⁵ All citations herein to [Bankr. Dkt. No. ___] refer to the docket in *In re Bernard L. Madoff Secs. LLC*, No. 08-1789 (Bankr. S.D.N.Y.).

⁶ Citations to the Joint Appendix [Dkt. Nos. 172-74] will appear herein in the following format: A-[Volume Number]:[Page Number(s)].

II. ISSUE PRESENTED FOR REVIEW

In SIPA a liquidation proceeding, customers of a failed broker-dealer may submit claims for “net equity,” defined as:

the dollar amount of the account or accounts of a customer, to be determined by –

(A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer . . . ; minus

(B) any indebtedness of such customer to the debtor on the filing date

§ 78III(11).

Did the Bankruptcy Court err in ruling that, when determining customer claims, the Trustee must disregard fraud victims’ brokerage account statements, when “net equity” is based on what the broker-dealer “owed” customers and SIPA is a remedial statute enacted to promote investor confidence?

III. STATEMENT OF THE CASE

Appellants are customers of Bernard L. Madoff Investment Securities LLC (“BLMIS”) who submitted timely claims for “net equity” to the Trustee in the SIPA liquidation proceeding pending before the Bankruptcy Court. The Appellants claimed “net equity” amounts that corresponded to the balances set forth on their respective final BLMIS account statements -- what the Bankruptcy Court referred to as the Last Statement Method.

The Trustee disallowed the Appellants' claims by adopting a so-called Net Investment Method, pursuant to which "net equity" is calculated by adding the Appellants' principal contributions to BLMIS, subtracting any withdrawals, and disregarding any reported earnings on Appellants' brokerage account statements. The Appellants timely objected to the Trustee's disallowance of their claims.

The Bankruptcy Court set a briefing schedule pursuant to which the Trustee, and the Securities Investor Protection Corporation ("SIPC") submitted briefs seeking approval of the Net Investment Method, and the Appellants and numerous other customers submitted briefs in support of the Last Statement Method.⁷ The Securities & Exchange Commission ("SEC") submitted a brief urging that the Trustee should calculate customer claims to include a rate of interest to account for the time value of customer monies deposited with BLMIS.⁸

⁷ Appellants requested the Bankruptcy Court's permission to brief whether "net equity" should include interest or the time value of monies deposited with BLMIS. *See* Objection to Proposed Order (Sept. 14, 2009) [Bankr. Dkt. No. 422]; Letter to Judge Lifland in Response to Trustee's Proposed Order Scheduling Adjudication of "Net Equity" Issue (Sept. 14, 2009) [Bankr. Dkt. No. 423]. However, the Bankruptcy Court specifically limited the issue to be briefed to whether "net equity" should be calculated using the Net Investment Method or the Last Statement Method, reserving all other issues for a later date. *See* Order Scheduling Adjudication of "Net Equity" Issue (Sept. 16, 2009) (A-I:264); Letter Endorsement (Sept. 16, 2009) [Bankr. Dkt. No. 438].

⁸ *See* Memorandum of the SEC Supporting Trustee's Determination That Net Equity Should Not Be Based on Securities Positions Listed On Last Statements, and Supporting in Part Trustee's Determination That Net Equity Should Be Based

On March 8, 2010, the Bankruptcy Court issued the Net Equity Order (SPA-60) approving the Trustee's Net Investment Method for the reasons described in the Memorandum Decision (SPA-7) ("Decision") issued on March 1, 2010.

Appellants appeal therefrom.

IV. FACTS

A. Madoff's Fraud

BLMIS, founded in 1960, was a New York limited liability company wholly owned by Bernard L. Madoff. *See* Decision at 8 (SPA-14). BLMIS was organized into three business units: the market making unit, the proprietary trading unit, and the investment advisory business. *Id.* at 9 (SPA-15). BLMIS was registered with the SEC as a broker-dealer under Section 15(b) of the Securities Exchange Act of 1934. *Id.* at 8 (SPA-14). By virtue of this registration, BLMIS was a member of SIPC. *Id.* at 8-9 (SPA-14-15).

SIPC is a non-profit corporation with the authority to adopt rules and bylaws "as may be necessary or appropriate to carry out the purposes of [SIPA]," including rules relating to "the distribution of customer property, and the advance and payment of SIPC funds." § 78ccc(b)(4)(B). These rules and bylaws must be approved by the SEC, which has supervisory authority over SIPC. §§ 78ccc(e)(1), 78ggg.

Upon Amounts Deposited Less Amounts Withdrawn ("SEC Brief") [Bankr. Dkt. No. 1052].

On December 11, 2008, Madoff was arrested and charged with various criminal counts based upon his theft of customer monies. *See* Decision at 6-7 (SPA-12-13). Madoff pled guilty to all charges and is currently serving a 150-year prison sentence. *Id.* at 7 (SPA-13).

In his plea allocution, Madoff stated that he represented to clients that he would invest their money in blue chip securities pursuant to a “split strike conversion” investment strategy:

Through the split-strike conversion strategy, I promised . . . that client funds would be invested in a basket of common stocks within the Standard & Poor’s 100 Index I promised that I would opportunistically time these purchases and would be out of the market intermittently, investing client funds during these periods in United States Government-issued securities such as United States Treasury bills. In addition, I promised that as part of the split strike conversion strategy, I would hedge the investments I made in the basket of common stocks by using client funds to buy and sell option contracts related to those stocks, thereby limiting potential client losses caused by unpredictable changes in stock prices.

Plea Allocution of Bernard L. Madoff (“Madoff Plea Allocution”) (A-II:292-93); *see also* Decision at 13-14 (SPA-19-20). Madoff further described that his “representations [to customers] were false because for many years up and until I was arrested on December 11, 2008, I never invested those funds in the securities, as I had promised. Instead, those funds were deposited in a bank account at Chase Manhattan Bank.” Madoff Plea Allocution (A-II:291).

The Bankruptcy Court indicated that BLMIS operated solely as a Ponzi scheme throughout its entire existence. Decision at 9 (SPA-15). However, the record indicates that the BLMIS market making and propriety trading divisions operated as “legitimate” enterprises that Madoff described as “profitable.” Madoff Plea Allocution (A-II:292); *see also* Declaration of Joseph Looby (“Looby Decl.”) at ¶ 28 (A-I:506) (“The market making and proprietary trading business units appear to have been largely involved in legitimate trading . . .”).

Moreover, information submitted by the Trustee indicates that the fraud began in the early 1990s, such that Appellants and other customers may have earned some legitimate earnings on investments.⁹ In his plea allocution, Madoff stated that “to the best of my recollection, my fraud began in the early 1990s” at a time when “the country was in a recession.” Madoff Plea Allocution (A-II:292). One of Madoff’s co-conspirators, Frank DiPascali, stated at his plea hearing that “from the early 1990s until December of 2008 I helped Bernard Madoff . . . carry out the fraud that hurt thousands of people.” Dipascali Plea Hearing Tr. at 44:18-25 (A-I:363).

⁹ Although many BLMIS customers who filed claims in the liquidation proceeding opened accounts with BLMIS in the 1980s if not earlier, the Trustee’s motion below appears to identify only BLMIS customers who opened accounts in the early 1990s, perhaps to evade arguments that the Net Investment Method improperly disallows claims for legitimate earnings accrued before the inception of the fraud.

In 1992, Madoff provided information to the SEC indicating that he was executing actual trades at that time. SEC Inspector General Interview With Madoff at 8 (A-II:305) (describing that “the SEC saw that the trades were real in 1992”). In addition, Madoff separated his investment advisory business from his other business units “[i]n or around 1993” and began using the IBM AS/400 computer system to generate phony customer statements “[i]n or around 1993.” Looby Decl. ¶¶ 14-15 (A-I:504).

Notwithstanding the foregoing, the Bankruptcy Court found that BLMIS “*never* truly acted as a legitimate investment advisor.” Decision at 9 (SPA-15) (emphasis added).

B. A SIPA Liquidation Proceeding is Commenced

On December 15, 2008, SIPC petitioned the District Court to commence a SIPA liquidation proceeding against BLMIS and appoint Irving Picard as trustee (“Trustee”).¹⁰ See Decision at 7 (SPA-13). The District Court granted SIPC’s application and removed the liquidation proceeding to the Bankruptcy Court. *Id.* The liquidation proceeding is governed by SIPA, which incorporates provisions of the Bankruptcy Code to the extent consistent with SIPA. § 78fff(b).

¹⁰ In contrast to a traditional bankruptcy proceeding, in a SIPA liquidation, SIPC has the “sole discretion” to select the trustee. § 78eee(b)(3).

On December 23, 2008, the Bankruptcy Court issued an Order providing for a BLMIS customer claims process. *See* Decision (SPA-13). The Appellants are customers of BLMIS who filed “net equity” claims, pursuant to Section 7811(11), that corresponded to the securities positions set forth on their final BLMIS account statements. The Bankruptcy Court called this the Last Statement Method, and for the sake of consistency, the Appellants will use this terminology herein. *See generally* Decision.

Appellants’ monthly BLMIS account statements showed purchases of listed securities at prices that corresponded to publicly available trade data. *See* Exemplar Customer Account Statements (A-III:757-805). As described by two elderly victims who lost their life’s savings in Madoff’s scheme, “Every monthly securities account statement that we received read like an investment portfolio composed of legitimate and well-known stocks As investment laypeople, these statements appeared legitimate and provided us with a peace of mind that our investments were in good hands and secure.” Affidavit of Norman Plotnick and Yetta Goldman ¶ 4 (A-III:370).

BLMIS provided the Appellants account statements, trade confirmations, 1099 Forms, and other documentation reporting investment income on which Appellants paid taxes. *See* Appellants’ Objections cited at Addendum A; *see also* Bernard Seldon’s Objection to Trustee’s Determination of Claim [Bankr. Dkt. 453]

(including as exhibit Form 1099). Customers whose Individual Retirement Accounts (“IRAs”) were “managed” by BLMIS were required by law to receive distributions after age 70 ½ and pay corresponding income taxes. *See* 26 C.F.R. § 1.408-2(b)(6) (requiring mandatory IRA distributions after age 70 ½); *see also* Bernard Seldon’s Objection to Trustee’s Determination of Claim [Bankr. Dkt. 453].

Notwithstanding these considerations, the Trustee disallowed the Appellants’ claims by calculating their “net equity” based on their principal contributions to BLMIS, less any withdrawals, without regard to earnings reflected on their customer account statements and without acknowledging the time value of their money, as urged by the SEC.¹¹ *See* Claim Determination Letters of Milberg Appellants (A-II:611-97). The Bankruptcy Court referred to this as the Net Investment Method, and again, for the sake of consistency, Appellants use that terminology herein, though it is a misnomer in that it gives effect only to customer principal, not investments. The charts included as Addendum A reflect how each Appellant’s “net equity” fares under the Last Statement Method versus the Net Investment Method. *See* Addendum A.

¹¹ *See* SEC Brief [Bankr. Dkt. No. 1052].

After the submission of briefing by interested parties, the Bankruptcy Court issued the Net Equity Order (SPA-60), approving the Net Investment Method for the reasons described in the Decision (SPA-7).

Appellants appeal from this ruling.

V. SUMMARY OF THE ARGUMENT

SIPA provides that in a broker-dealer liquidation, a customer may submit a claim for “net equity” based on what the broker-dealer “owed” the customer “on the filing date.” § 78III(11). SIPA, legislative history, Second Circuit precedent, and other authorities provide that what the broker-dealer “owed” the customer “on the filing date” is determined by reference to the customer’s last brokerage account statement prior to the liquidation.

Citing the circumstances of the fraud, the Bankruptcy court adopted the Net Investment Method to calculate “net equity.” *See* Decision. Under the Net Investment Method, the Trustee limits “net equity” to any principal remaining in the customer’s account by adding up the customer’s contributions over the life of the account, subtracting any withdrawals, and disregarding any earnings reported on customer account statements.

The Bankruptcy Court’s ruling was erroneous because the Net Investment Method does not result in a “net equity” amount reflective of what BLMIS “owed” its customers “on the filing date,” as clearly and unambiguously required by SIPA.

§ 78III(11). Moreover, the Net Investment Method disregards binding precedent, contravenes SIPA's legislative history, acts as an unauthorized avoidance power, and incorrectly assumes that BLMIS was a Ponzi scheme in its entirety since the 1960s.

Accordingly, the Net Equity Order should be reversed.

VI. STANDARD OF REVIEW

This Court reviews de novo the Bankruptcy Court's legal conclusions, while findings of fact are upheld unless "clearly erroneous." *See Cadle Co. v. Mangan (In re Flanagan)*, 503 F.3d 171, 179 (2d Cir. 2007); *In re New Times Secs. Servs., Inc.*, 371 F.3d 68, 75 (2d Cir. 2004) ("*New Times I*").

VII. ARGUMENT

A. Introduction

In a SIPA liquidation proceeding, customers of a failed broker-dealer may submit claims for "net equity" based on the amounts the broker-dealer "owed" them "on the filing date." § 78III(11). If customer claims exceed the broker-dealer's "fund of customer property," then SIPC must advance to the Trustee up to \$500,000 per customer "to provide for prompt payment and satisfaction of net equity claims of customers." § 78fff-3(a). SIPC's advances are funded by the "SIPC Fund," which SIPC maintains through annual assessments on broker-dealers. § 78ddd.

At issue is whether claims for “net equity” should be calculated using the Net Investment Method or the Last Statement Method (or some other approach). This issue is of crucial importance to Appellants because it will determine whether and to what extent they will be entitled to an advance from the SIPC Fund, which is likely to be their only source of meaningful recovery.

The Appellants argued that “net equity” should be based on the balances set forth on their brokerage account statements, in accordance with SIPA’s plain meaning and Second Circuit precedent. *See New Times I*, 371 F.3d 68, 74 (2d Cir. 2004) (noting that “net equity” was based on customers account statements depicting listed securities that were never purchased); *see also Stafford v. Giddens (In re New Times Secs. Servs., Inc.)*, 463 F.3d 125, 128 (2d Cir. 2006) (“*New Times II*”) (“It is a customer’s legitimate expectations on the filing date . . . that determines the availability, nature, and extent of customer relief under SIPA.”).

Instead, the Bankruptcy Court erroneously adopted the so-called Net Investment Method, which reduces claims to any principal remaining in a customer’s BLMIS account. In so holding, the Bankruptcy Court ruled that the Trustee must calculate customer claims based on the transactions, or lack thereof, set forth in BLMIS’s secret “books and records,” which have never been provided to Appellants and do not indicate what BLMIS “owed” them. Decision at 22 (SPA-28).

To justify its deviation from the statute, the Bankruptcy Court erroneously held that equity favors the Net Investment Method. In fact, the Net Investment Method punishes innocent customers who reasonably relied upon their brokerage account statements, sending the message that customers must “audit” their broker-dealer or revert to the decades-ago practice of requesting stock certificates rather than holding securities in “street name.” Moreover, the Bankruptcy Court’s Decision:

- fails to acknowledge that customers paid taxes on their purported earnings;
- fails to acknowledge that many BLMIS customers were required to receive mandatory retirement account distributions - distributions that the Trustee has threatened to “claw back”;
- gives no effect to the time value of customer monies deposited with BLMIS;
- incorrectly assumes that BLMIS operated entirely as a Ponzi scheme since its inception, when the record reflects that some portions of the business were legitimate and that the fraud did not begin until the early 1990s; and
- deprives more than half of BLMIS’s customers of any recovery.

The comparison below illustrates the operation of the two approaches. Appellants Judith Rock Goldman and Bernard Seldon opened their respective BLMIS IRA accounts in 1992, such that their final BLMIS account statement balances included reported earnings accrued over the 16-year life of their accounts -- earnings they reasonably relied upon in retiring.

Judith Rock Goldman (IRA), Claim No. 009794, Objection [Bankr. Dkt. No. 396]

Last Statement Method	Net Investment Method
Nov. 30, 2008 BLMIS Account Statement Balance: \$213,899.91	Total Deposits: \$54,878.00 Total Withdrawals: (\$5,500)
<u>Net Equity: \$213,899.91</u>	<u>Net Equity: \$49,378.00</u>

Bernard Seldon (IRA), Claim No. 006615, Objection [Bankr. Dkt. No. 453]

Last Statement Method	Net Investment Method
Nov. 30, 2008 BLMIS Account Statement Balance: \$1,169,784.50	Total Deposits: \$1,097,394.77 Total Withdrawals: (\$2,256,804.50)
<u>Net Equity: \$1,169,784.50</u>	<u>Net Equity: \$(1,159,409.73)</u>

Although Ms. Goldman's November 30, 2008 BLMIS account statement showed a balance of \$213,899.91, under the Net Investment Method, her claim is reduced to her principal, which is a mere \$49,378.00, most of which was deposited back in 1992. *See* Goldman Claim Determination Letter (A-II:642-44). Mr. Seldon fares even worse, because under the Net Investment Method, he is, under the Trustee's parlance, a "net winner" from whom the Trustee may assert an avoidance claim to recover the amounts he received in excess of his principal. *See* Seldon Claim Determination Letter (A-II:687-91); Michael Rothfeld, *Madoff*

Investors Brace for Lawsuits, WALL STREET JOURNAL, July 26, 2010 at C1 (“[I]rving Picard said he could wind up suing about half the estimated 2,000 individual investors he has called ‘net winners.’”). Given that even under the Last Statement Method, Mr. Seldon has lost more than half of his retirement savings, he is hardly a “winner.”

Of the 4,903 active BLMIS accounts on the filing date, the Net Investment Method results in a total claim disallowance for 2,568 customer accounts for which total withdrawals exceeded total deposits. *See* Transcript of Interview With Trustee (A-II:124-25). For the 2,335 accounts for which total deposits exceeded total withdrawals, the Net Investment Method reduces customer claims to any remaining principal, notwithstanding years of reported earnings on brokerage account statements upon which customers reasonably relied. By minimizing the number and amount of customer claims, the Net Investment Method saves SIPC an estimated \$1 billion.¹² In this regard, the liquidation is not a “zero sum game,” as described by the Bankruptcy Court. Decision at 31 (SPA-37). Rather, every customer may recover up to \$500,000 from SIPC without reducing the amount available to pay any other customer. § 78fff-3(a). The Trustee’s narrow and strained interpretation of SIPA operates to deprive Appellants of this advance.

¹² This estimate is based on each of the 2,568 claims denied under the Net Investment Method having a “net equity” of at least \$400,000 under the Last Statement Method.

At the outset, it must be noted that while bankruptcy trustees are generally afforded some deference as to matters of claims administration, no such deference is warranted here.¹³ The Trustee and his counsel were chosen and are paid by SIPC, and as such, they are financially incentivized to act at the behest of SIPC, which is an adverse party to Appellants. §§ 78eee(b)(5). One court described the relationship between SIPC and its trustees as follows, concluding with a warning to other courts presiding over SIPA cases:

[F]or all practical purposes the trustee has been a puppet for SIPC since the inception of this case. SIPC . . . has an interest completely divergent from that of almost all other creditors. Clearly the trustee would not be a

¹³ Neither SIPC nor the SEC argued below that their respective interpretations of “net equity” are entitled to deference. This Court has previously ruled that SIPC’s interpretation of SIPA’s customer claims provisions is not entitled to any deference where, as here, the SEC has presented a conflicting interpretation. *See New Times I, Inc.*, 371 F.3d 68, 80 (2d Cir. 2004) (“Congress did not intend for the [SEC’s] interpretations of SIPA to be overruled by deference to the entity that was made subject to the [SEC’s] oversight.”). Similarly, this Court has held that the SEC’s interpretation of “net equity” is not entitled to *Chevron* deference, in part because its position “has never been articulated in any rule or regulation,” despite its rulemaking authority, and because “the SEC generally adopts a hands-off approach with respect to SIPC liquidations (and litigation).” *Id.* at 81-82 (holding that SEC interpretation of SIPA was entitled only to *Skidmore* deference); *see generally Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984).

In any event, “[d]eference to what appears to be nothing more than an agency’s convenient litigating position would be entirely inappropriate.” *Bowen v. Georgetown Universal Hosp.*, 488 U.S. 204, 213 (1988). In addition, “a reviewing court should not defer to an agency position which is contrary to an intent of Congress expressed in unambiguous terms.” *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 476 (1992).

“disinterested person” if the bankruptcy definition, 11 U.S.C. § 101(13)(E), were controlling in this instance.

.....

SIPC may name the trustee and . . . controls the trustee’s compensation. . . . The effect of these and other provisions is to give the trustee in these cases the appearance of independence while assuring his domination and control by SIPC.

.....

The asserted justification for this extraordinary deception is that SIPC provides the funds to pay the creditors. This is a half truth. The SIPC Fund is raised from compulsory assessments . . . paid by all registered securities brokers and dealers. In effect, therefore, the Fund is nothing more or less than a compulsory insurance premium mandated by federal law, collected from brokers but charged to all securities investors.

In return, the creditor/customer who has suffered a loss gets what appears to be an independent, impartial claims analysis by an officer of a federal court, but all he really gets is a decision by the insurance company’s claims agent, its captive trustee.

.....

Congress should revisit this statute. . . . In the meantime, I would encourage my colleagues to be mindful of the extraordinary affinity between SIPC and its trustee throughout the administration of these cases.

In re First State Secs. Corp., 39 B.R. 26, 27-29 (Bankr. S.D. Fla. 1984) (internal citations omitted). The Net Investment Method advocated by the Trustee below must be viewed in light of this financial arrangement.

For the reasons described below, the Net Equity Order should be reversed.

B. The Bankruptcy Court's Ruling Contravenes Clear and Unambiguous Statutory Provisions

In approving the Net Investment Method, the Bankruptcy Court ruled that in determining customer claims for “net equity,” as defined in SIPA Section 78III(11), the Trustee must look solely to the transactions, or lack thereof, reflected in BLMIS’s internal “books and records,” ignoring account statements and other evidence of what BLMIS “owed” his customers. Decision at 22 (SPA-28). This ruling contravenes the plain meaning of the statutory provisions at issue, which require application of the Last Statement Method.

“The controlling principle in this case is the basic and unexceptional rule that courts must give effect to the clear meaning of statutes as written.” *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 476 (1992). “Statutory interpretation always begins with the plain language of the statute, which we consider in the specific context in which that language is used, and the broader context of the statute as a whole.” *ASM Capital, LP v. Ames Dep’t Stores, Inc. (In re Ames Dep’t Stores, Inc.)*, 582 F.3d 422, 427 (2d Cir. 2009) (internal citations/quotations omitted).

“The plain meaning can be extrapolated by giving words their ordinary sense.” *NRDC v. Muszynski*, 268 F.3d 91, 98 (2d Cir. 2001); *see also Perrin v. United States*, 444 U.S. 37, 42 (1979) (“A fundamental canon of statutory

construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.”).

As noted above, in the event of a broker-dealer liquidation, SIPC must advance from the SIPC Fund up to \$500,000 per customer to “promptly” satisfy “net equity” claims for securities. §78fff-3. SIPA defines “net equity” as:

the dollar amount of the account or accounts of a customer, to be determined by--

(A) calculating the sum *which would have been owed by the debtor* to such customer if the debtor had liquidated, by sale or purchase *on the filing date*, all securities positions of such customer . . . ; minus

(B) any indebtedness of such customer to the debtor on the filing date

§ 78lll(11) (emphasis added). Notably, the definition of “net equity” contains *no* reference to the debtor’s “books and records,” though this term is used in other SIPA provisions. *See Milwaukee v. Illinois*, 451 U.S. 304, 329 (1981) (“We prefer to read the statute as written. Congress knows how to say ‘nothing in this Act’ when it means to.”).

Pursuant to this definition, a customer’s “net equity” claim is based on what the debtor “owed” the customer “on the filing date.” § 78lll(11). Though neither SIPA nor the Bankruptcy Court define the word “owe,” the term generally means “to be under obligation to pay or repay in return for something received.” MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2002). Courts have held

that the word “owe” is clear and unambiguous. *See In re Leggett*, 335 B.R. 227, 230 (Bankr. N.D. Ga. 2005) (“[T]he plain meaning of ‘owe’ is ‘to be under an obligation to pay.’”); *see also Choice Hotels Int’l, Inc. v. BSR Tropicana Resort, Inc.*, 252 F.3d 707, 710 (4th Cir. 2001) (noting that Black’s Dictionary provides that “[t]o ‘owe’ means ‘to be bound to do or omit something, especially to pay a debt’”).

SIPA’s definition also contains a temporal limitation -- that the Trustee must look to what the debtor “owes” the customer “on the filing date.” § 78III(11); *see also SIPC v. Lehman Bros. Inc.*, No. 08-1420, 2010 Bankr. LEXIS 1623, at *16 (Bankr. S.D.N.Y. June 1, 2010) (“As is clear from the definition, net equity is calculated as of the filing date.”). Thus, SIPA does not permit the Trustee to go back decades to add customer deposits, subtract withdrawals, and negate any purportedly illusory earnings.

The “books and records” provision cited by the Bankruptcy Court as a purported limitation on SIPA’s definition of “net equity” must likewise be given its plain meaning. This provision, which governs the Trustee’s obligations and has no bearing on how to calculate “net equity,” provides as follows:

Payments to customers. After receipt of a written statement of claim . . . , the trustee shall promptly discharge . . . all *obligations* of the debtor to a customer relating to, or *net equity claims* based upon, securities or cash, by the delivery of securities or the making of payments to or for the account of such customer . . .

insofar as such obligations are ascertainable from *the books and records of the debtor or are otherwise established to the satisfaction of the trustee.*

§ 78fff-2(b) (emphasis added).

“Obligation” is not defined in SIPA or the Bankruptcy Code. The term generally means “something one is bound to do.” MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2002). Courts have held that the word “obligation,” albeit in a different bankruptcy context, is clear and unambiguous. *See R.H. Macy & Co. v. Bullock’s Inc.*, No. 93-4414, 1994 U.S. Dist. LEXIS 21364, at *31 (S.D.N.Y. Feb. 23, 1994) (holding that the word “obligation” as used in Bankruptcy Code Section 365(d)(3) is “clear and unambiguous”) (Sotomayor, J. affirming Lifland, J.); *see also In re Designer Doors, Inc.*, 389 B.R. 832, 836 (Bankr. D. Ariz. 2008) (same).

Section 78fff-2(b) further provides that “net equity” claims and the debtor’s “obligations” to customers must be “ascertainable from *the books and records of the debtor*” or “*otherwise established to the satisfaction of the trustee.*” § 78fff-2(b). Judge Lifland misinterpreted this provision to mean that the debtor’s secret “books and records” showing illegal activity dictate customer claims amounts, rather than the representations BLMIS made to its customers through account statements and other communications. Decision at 22 (SPA-28). This was error.

Madoff's internal books and records may show fraud, but that is not evidence of the amounts Madoff "owed" his customers or his "obligations" to them. *See Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 480 (1992) ("The plain meaning of [one] subsection . . . cannot be altered by the use of a somewhat different term in another part of the statute."). In other words, the Trustee should look to BLMIS's "books and records," not to ascertain whether securities were actually purchased, but rather, to ascertain what BLMIS "owed" its customers and its "obligations" to them "on the filing date." § 78III(11). Moreover, as the monthly account statements BLMIS sent customers are part of its "books and records," it was error for Judge Lifland to hold that they must be disregarded.¹⁴

Substantive state and federal law also inform what BLMIS owed its customers. *See Travelers Cas. & Sur. Co. of Am. v. PG&E*, 549 U.S. 443, 450 (2007) ("[B]ankruptcy courts [must] consult state law in determining the validity of most claims."); *Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 20 (2000) ("Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code."). This is consistent

¹⁴ 17 C.F.R. § 240.17a-4(b)(4) (requiring broker-dealers to maintain all records of communications sent and received); 17 C.F.R. § 240.17a-4(c) (requiring broker-dealers to maintain records relating to customer accounts).

with Bankruptcy Code Section 502(b)(1), incorporated by SIPA in Section 78fff(b), which provides that a claim in bankruptcy shall be allowed “except to the extent that . . . such claim is unenforceable . . . under . . . *applicable law*” See 11 U.S.C. § 502(b)(1).

Under New York and federal securities laws, BLMIS’s customer agreements and customer account statements created obligations BLMIS owed its customers under any number of theories, including breach of contract, Article 8¹⁵ of New York’s Uniform Commercial Code, and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. That no securities were purportedly purchased specifically for Appellants does not change the obligations owed, and because broker-dealers generally hold securities “in street name,”¹⁶ BLMIS would not be expected to hold securities in the names of customers.

¹⁵ Under Article 8, “[a] customer becomes an entitlement holder as soon as the intermediary makes a book entry indicating that the customer has bought shares. One important effect of this structure is that a brokerage customer can become an entitlement holder even if the broker has not, in fact, acquired the shares credited to the customer’s account, and even if the broker does not own a single share of the security.” Marcel Kahn & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 Geo. L.J. 1227, 1242 (2008).

¹⁶ When securities are held in “street name,” the “security is registered in the name of your brokerage firm on the issuer’s books, and your brokerage firm holds the security for you in ‘book-entry’ form. ‘Book-entry’ simply means that you do not receive a certificate. Instead, your broker keeps a record in its books that you own that particular security. . . . While you will not receive a certificate, your firm will send to you, at least four times a year, an account statement that lists all your

In any event, Section 78fff-2(b) expressly provides that the Trustee may discharge the debtor's "obligations" to customers to the extent they "are ascertainable from the books and records of the debtor *or are otherwise established to the satisfaction of the trustee.*" § 78fff-2(b) (emphasis added). Judge Lifland failed to discuss this latter clause, but SIPC has discussed its meaning before this Court in another recent SIPA liquidation.

In *New Times*, a factually similar SIPA liquidation involving a Ponzi scheme discussed further below, SIPC argued that if a customer can establish a claim independently of the debtor's "books and records," then the "books and records" are not determinative:

Congress was careful . . . to provide that a "customer" claimant may establish a "net equity" claim *independently of the broker's books and records*, to the extent that the claimant can do so "to the satisfaction of the trustee." To do so consistent with SIPA's purposes, the claimant must prove that he or she reasonably expected that the liquidating broker owed him or her cash or securities as a brokerage customer on the filing date; i.e., that the claimant believed that he or she was engaged in ongoing securities trading on the filing date.

Reply Brief of SIPC, *Stafford v. Giddens (In re New Times Secs. Servs., Inc.)*, No. 05-5527, 2006 U.S. 2d Cir. Briefs LEXIS 114, at *14 (2d Cir. Feb. 16, 2006) (A-III:159) (emphasis added) (internal citations omitted). The Appellants met this

securities at the broker-dealer." "Holding Your Securities -- Get the Facts," SEC website, www.sec.gov/investor/pubs/holdsec.htm (last visited on Aug. 9, 2010).

standard by submitting their final BLMIS account statements to the Trustee with their customer claims.

In sum, the Net Equity Order should be reversed because it authorizes the Trustee to improperly disallow customer claims in the face of incontrovertible evidence that BLMIS “owed” customers securities. This approach violates SIPA’s plain meaning, and as discussed below, conflicts with Second Circuit precedent.

C. The Bankruptcy Court’s Ruling Conflicts With Second Circuit Precedent in *New Times I*

The Bankruptcy Court held, erroneously, that *New Times I*, 371 F.3d 68 (2d Cir. 2004), a factually similar SIPA case, calls for the application of the Net Investment Method. Decision at 25-30 (SPA-31-36). In fact, *New Times I* supports the Last Statement Method.

New Times I arose out of a 17-year Ponzi scheme perpetrated by William Goren, who “solicited customers . . . to invest in (i) one or more non-existent money market funds . . . [the Fake Securities Claimants], [and] (ii) shares of bona fide mutual funds (from, e.g., The Vanguard Group and Putnam Investments), that were never, in fact, purchased [the Real Securities Claimants]. . . . Instead of investing these customers’ funds as represented, Goren misappropriated the money.” *New Times I*, 371 F.3d at 71-72.

Like the Appellants, the Real Securities Claimants in *New Times I* received account statements showing purchases of bona fide securities (*i.e.*, The Vanguard

Group and Putnam Investments), which Goren never in fact purchased. *Id.* As to these investors, the SIPA trustee in *New Times I* calculated “net equity” based on the customer account statements showing bona fide securities, even though in *New Times I*, like this case, the broker-dealer was operating as a Ponzi scheme and never purchased the securities. *Id.* at 74; *see also* Trustee ‘s Opening Brief Below at 41 (“It is true that for claimants who believed that they had invested in ‘real’ mutual funds in *New Times*, the trustee calculated net equity based upon ‘earnings’ on those investments as represented on their customer statements.”) [Bankr. Dkt. No. 525]. With regard to the Fake Securities Claimants, whose statements depicted bogus money market funds that did not exist and as such could not have been purchased, the *New Times I* trustee applied the Net Investment Method. *New Times I*, 371 F.3d at 74.

Though *New Times I* was focused primarily on the treatment of the Fake Securities Claimants, the Second Circuit’s discussion of the Real Securities Claimants’ more favorable treatment is pertinent:

[I]nvestors who were misled by Goren to believe that they were investing in mutual funds that in reality existed were treated much more favorably [than the customers whose statements showed bogus mutual funds]. Although they were not actually invested in those real funds -- because Goren never executed the transactions -- the information that these claimants received on their account statements mirrored what would have happened had the transactions been executed. As a result, the Trustee deemed those customers’ claims to be ‘securities

claims' eligible to receive up to \$500,000 in SIPC advances. The Trustee indicates that this disparate treatment was justified because he could purchase real, existing securities to satisfy such securities claims. Furthermore, the Trustee notes that [those customers who thought they owned bona fide securities] could have confirmed the existence of those funds and tracked the funds' performance against Goren's account statements.

New Times I, 371 F.3d at 74 (internal citations omitted). After discussion of the statutory language, SIPA's legislative history, and the Series 500 Rules, the Court ruled that the Net Investment Method was proper as to the Fake Securities Claimants, but emphasized: "[t]o be clear -- and this is the *crucial fact* in this case -- the New Age Funds in which the [Fake Securities] Claimants invested never existed." *Id.* (emphasis added).

Here, the securities do exist, and as such, the Appellants are like the Real Securities Claimants in *New Times I* whose claims for "net equity" were calculated using the Last Statement Method. The Appellants' BLMIS statements reflected ownership of bona fide securities (*i.e.*, Wal-Mart Stores Inc., Johnson & Johnson, Coca Cola Co., Microsoft, and Pfizer) the existence and value of which could be confirmed against publicly available data. *See Exemplar Customer Account Statements* (A-III:757-805). These are the considerations the Second Circuit deemed "crucial" in *New Times I*. *New Times I*, 371 F.3d at 74.

Notably, in a later appeal in *New Times*, SIPC advocated to this Court that the Last Statement Method was correct:

Of vital importance here, reasonable and legitimate claimant expectations on the filing date are controlling *even where inconsistent with transactional reality*. Thus, for example, where a claimant orders a securities purchase and *receives a written confirmation statement* reflecting that purchase, the claimant generally has a reasonable expectation that he or she holds the securities identified in the confirmation *and therefore generally is entitled to recover those securities* (within the limits imposed by SIPA), *even where the purchase never actually occurred and the debtor instead converted the cash deposited by the claimant to fund the purchase*.

Brief of SIPC, *Stafford v. Giddens (In re New Times Secs. Servs., Inc.)*, No. 05-5527, 2005 U.S. 2d Cir. Briefs LEXIS 259, at *23-24 (Dec. 30, 2005) (A-III:150) (emphasis added).

Rather than focusing on the depiction of bona fide securities on customer account statements -- what the Second Circuit deemed “crucial” to its ruling in *New Times I* -- the Bankruptcy Court instead engaged in a *post hoc* analysis of the alleged particulars of Madoff’s fraud to conclude that the Appellants are situated similarly to the Fake Securities Claimants in *New Times I*, rather than the Real Securities Claimants. Decision at 29 (SPA-35). The Bankruptcy Court’s rationale for this determination was that “[a]lthough the securities that Madoff allegedly purchased were identifiable in name, the securities positions reflected on customer account statements were artificially constructed. By backdating trades to produce predetermined, favorable returns, Madoff . . . essentially pulled fictitious amounts from thin air.” *Id.*

There is nothing in the record to indicate that Madoff's purported trades in bona fide securities were any more or less "fictional" than those of the Real Securities Claimants in *New Times*. See Exemplar Customer Account Statements (A-III:757-805). In both cases, customer account statements showed purchases of bona fide securities that tracked market prices.¹⁷ *New Times I*, 371 F.3d at 74; Cf. *SIPC v. Oberweis Secs., Inc. (In re Oberweis Secs., Inc.)*, 135 B.R. 842, 847 n.1 (Bankr. N.D. Ill. 1991) ("[The claimants] never received confirmation that the securities were in fact purchased. The court agrees with the trustee's argument that Congress did not intend to treat customers without confirmations the same as those with confirmations . . .").¹⁸

¹⁷ The Bankruptcy Court noted only one instance where a BLMIS statement reflected a securities purchase outside the "high-low" range for the reported trade date. Decision at 14, 29 n. 34 (SPA-20, 35). Specifically, the Bankruptcy Court referred to a December 2006 account statement purportedly depicting a sale of Merck securities on December 22, 2006 at a price \$1.19 higher than the reported highest trade for that sale date. This aberration, which is likely due to the fraudster's error, is an insufficient basis to hold that the BLMIS final account statements "have no relation to reality." *Id.* at 29 (SPA-35).

¹⁸ The Bankruptcy Court found persuasive *Focht v. Athens (In re Old Naples Secs., Inc.)*, 311 B.R. 607 (M.D. Fla. 2002), a SIPA liquidation in which the court applied the Net Investment Method. Decision at 30 n.35 (SPA-36). However, *Old Naples* involved imaginary securities that did not exist and thus could not have been purchased. *Id.* at 613. Moreover, "the Transactions were not evidenced by the customary documentation found in municipal bond transactions. Such documentation includes confirmations, monthly statements, blotter entries, and trade tickets. *SIPC v. Old Naples Secs., Inc. (In re Old Naples Secs., Inc.)*, 343 B.R. 310, 322 (Bankr. M.D. Fla. 2006).

New Times I does not permit a court to conduct a *post hoc* analysis of the logistics of the fraud to determine in hindsight that the bona fide securities listed on customer statements are “pulled . . . from thin air.” Decision at 29 (SPA-35). That is not the test applied by the *New Times I* court, and it does not comport with SIPA. Accordingly, Judge Lifland’s Net Equity Order should be reversed.

D. The Bankruptcy Court’s Application of *New Times I* Rests on Clearly Erroneous Findings of Fact

In holding that the Appellants were situated most like the Fake Securities Claimants in *New Times I*, the Bankruptcy Court made two clearly erroneous factual findings. First, the Bankruptcy Court found that “at certain times” the Appellants “held at least one imaginary security.” Decision at 29 (SPA-35). Second, the Bankruptcy Court found that the Appellants’ “initial investments were insufficient to acquire their purported securities positions.” *Id.* at 30 (SPA-36). As no discovery has been taken, only minimal evidence was presented to the Bankruptcy Court on these issues, and that evidence does not support the Bankruptcy Court’s findings.

1. The Record Demonstrates That Appellants’ BLMIS Statements Showed Ownership of Real Securities

In holding that the Appellants are situated similarly to the Fake Securities Claimants in *New Times I*, the Bankruptcy Court found that “at certain times” the Appellants held “at least one imaginary security.” *Id.* at 29 (SPA-35).

In contrast to the Bankruptcy Court’s finding, the record contains ample evidence that the Appellants’ BLMIS statements showed they were invested in blue chip stocks and other listed securities. The record includes numerous BLMIS customer statements showing publicly-traded securities, *see* Exemplar Customer Account Statements (A-III:757-805), and Madoff stated in his plea allocution that he told customers their money was “invested in a basket of common stocks within the Standard & Poor’s 100 Index, a collection of the 100 largest publicly traded companies” Madoff Plea Allocution at 2 (A-II:292); *see also* Dipascali Plea Hearing Tr. at 45-46 (A-I:364-65) (“The clients were told that the strategy involved purchasing what we call [a] basket of blue chip common stocks.”).

In addition, the Looby Declaration submitted in support of the Trustee’s motion below acknowledged that customers were told they were invested in blue chip stocks:

- “This strategy consisted of purported investment in a basket of common stocks within the S&P 100 Index hedged by a collar of put and call options to limit the potential client investment loss (or gain) that may be caused by normal stock price volatility.” Looby Decl. ¶ 48 (A-I:509).
- “An examination of the BLMIS books and records reveals that the fictitious investment strategy focused on large cap stocks” *Id.* ¶ 49 (A-I:510).

Notwithstanding the foregoing, the Bankruptcy Court fixated on a BLMIS account statement depicting ownership of shares in the “Fidelity Spartan U.S. Treasury Money Market Fund,” the name of which was changed to “Fidelity U.S.

Treasury Money Market Fund” in 2005,¹⁹ as a basis for holding that the Appellants are like the Fake Securities Claimants in *New Times I*. Decision at 14, 29 n.34 (SPA-20, 35). The Fidelity Spartan Fund is the only “phony” security identified in the record, and it is a far cry from the non-existent “New Age” securities sold in *New Times*, given that Fidelity is an existing company, the Fidelity Spartan Fund still exists under a different name, and Fidelity continues to offer several similarly-named funds.²⁰ Moreover, the Bankruptcy Court offered no explanation for why a single renamed security should be dispositive of how “net equity” should be calculated.

Accordingly, the Bankruptcy Court erred in holding that the Appellants are situated similarly to the Fake Securities Claimants in *New Times I* on this basis.

¹⁹See Form 497, SEC File No. 33-52577 (Aug. 15, 2005), available at www.sec.gov/edgar.shtml (announcing that the “Fidelity U.S. Treasury Money Market Fund” would be renamed the “Fidelity U.S. Treasury Money Market Fund” and changing minimum initial investment amounts); see also “Fidelity Makes Changes to Certain Bond and Money Market Funds,” *Investment Advisor*, www.investmentadvisor.com (Aug. 18, 2005).

²⁰Such funds include: Spartan Intermediate Treasury Bond Index Fund, Spartan Long-Term Treasury Bond Index Fund, Spartan Short-Term Treasury Bond Index Fund, and Spartan Total Market Index Fund,. See Find a Fund, www.fidelity.com (last visited Aug. 9, 2010).

2. The Record Demonstrates that the Appellants' Initial Investments Were Sufficient to Acquire Their Initial Securities Positions

In holding that the Appellants are situated similarly to the Fake Securities Claimants in *New Times I*, the Bankruptcy Court erroneously found that the Appellants' "initial investments were insufficient to acquire their purported securities positions." Decision at 30 (SPA-36). However, neither the Appellants' initial deposits, nor their initial BLMIS account statements were before the Bankruptcy Court, and the Bankruptcy Court did not cite to any evidence in the record to support its finding.

In fact, information submitted by the Trustee indicates that customers' initial BLMIS account statements reflected securities that corresponded to customers' initial deposits. The Looby Declaration stated that "the initial basket on a customer statement reflected purported purchases of stock and/or options *comparable to the amount of principal invested with BLMIS.*" Looby Declaration ¶ 68 (A-I:513) (emphasis added). Although the Trustee purportedly has the Appellants' initial BLMIS account statements and records of initial deposits, this information was not provided to the Bankruptcy Court, Appellants, or included in the record.

Based on the foregoing, the Bankruptcy Court erred in finding that Appellants' initial deposits were insufficient to fund the securities purchases reflected on their initial statements.

E. Principles of Statutory Construction Call For the Last Statement Method

As noted above, courts must give effect to a statute's plain meaning, where the statutory language is clear and unambiguous, as it is here. However, "[i]f the plain meaning of a statute is susceptible to two or more reasonable meanings, i.e., if it is ambiguous, then a court may resort to the canons of statutory construction." *NRDC v. Muszynski*, 268 F.3d 91, 98 (2d Cir. 2001).

Assuming *arguendo* that the statutory provisions at issue are ambiguous, two canons of statutory construction are pertinent: "First, when determining which reasonable meaning should prevail, the text should be placed in the context of the entire statutory structure . . . and internal inconsistencies in the statute must be dealt with." *Id.* Second, "[l]egislative history and other tools of interpretation may be relied upon only if the terms of the statute are ambiguous." *Lee v. Bankers Trust Co.*, 166 F.3d 540, 544 (2d Cir. 1999).

These principles demonstrate that the Net Investment Method is improper, as discussed below.

1. The Net Investment Method Renders SIPA's Provisions Internally Inconsistent and Conflicts With SIPC's Rules

a. The Net Investment Method Nullifies the Definition of "Net Equity"

"It is a cardinal principle of statutory construction that a statute ought . . . to be so construed that . . . no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (internal citations/quotations omitted); *Eisenstein v. City of New York*, 129 S. Ct. 2230, 2234 (2009) ("[S]tatutes [must] be construed in a manner that gives effect to all of their provisions"); *N.Y. State Rest. Ass'n. v. N.Y. City Bd. of Health*, 556 F. 3d 114, 127 (2d Cir. 2009) (rejecting statutory interpretation that would render certain provisions of statute meaningless).

The Bankruptcy Court erred in holding that Section 78fff-2(b) requires the Trustee to calculate customer claims based on the transactions, or lack thereof, set forth in BLMIS's "books and records," rather than based on what BLMIS "owed" its customers as required by Section 78lll(11) because this interpretation nullifies SIPA's "net equity" definition. As noted above, "net equity" is "the sum which would have been "owed" by BLMIS to the customer "on the filing date," minus any amounts the customer owed BLMIS. § 78lll(11). Yet, under the Net Investment Method, the Trustee looks solely to the "books and records" of the debtor to determine only whether securities were actually purchased, and the

amounts “owed” by the debtor to customers are irrelevant. Under the Net Investment Method, the definition of “net equity” is thus superfluous.

In contrast, the Last Statement Method gives effect to *both* SIPA’s “net equity” definition set forth in Section 78lll(11) *and* the “books and records” provision set forth in Section 78fff-2(b) by recognizing that what a broker-dealer “owes” the customer is most likely reflected on the customer’s last account statement, § 78lll(11), but that the Trustee, who is in possession of all of the debtor’s “books and records,” may look beyond the last statement to ascertain what the broker-dealer “owes” the customer.²¹ § 78fff-2(b).

b. The Net Investment Method Conflicts with the Series 500 Rules, Which Emphasize Customer Account Statements in the Claims Process, Not the Debtor’s Internal Books and Records

In 1988, SIPC promulgated the Series 500 Rules, which govern whether a customer has a claim for cash (eligible for a \$100,000 advance from SIPC) or a claim for securities (eligible for a \$500,000 advance from SIPC). Rule 502(a) provides that “[w]here the Debtor held cash in an account for a customer, the customer has a ‘claim for securities’ *[i]f the Debtor has sent written confirmation to the customer* that the securities in question have been purchased for or sold to

²¹ For example, a customer account statement could reflect that a customer sent a check sent to BLMIS, but the “books and records” could reveal that the check later bounced.

the customer's account." 17 C.F.R. § 300.502(a) (emphasis added). Conversely, "[w]here [the Debtor] held securities in an account for a customer, the customer has a 'claim for cash' [i]f the Debtor has sent written confirmation to the customer that the securities in question have been sold for or purchased from the customer's account." 17 C.F.R. § 300.501(a) (emphasis added). "[U]nder SIPC's rules *it is not performance that is critical, but receipt of written confirmation of sale*. This is clear from the Rules themselves." *In re Investors Ctr., Inc.*, 129 B.R. 339, 350 (Bankr. E.D.N.Y. 1991) (emphasis added).

The Net Investment Method looks to customer account statements for determining *whether* a customer has a claim for cash or securities, but completely disregards customer account statements with regard to determining the *amount* of the claim. "A construction that creates an inconsistency should be avoided when a reasonable interpretation can be adopted which will not do violence to the plain words of the act, and will carry out the intention of Congress." *United States v. Raynor*, 302 U.S. 540, 547 (1938).

Only the Last Statement Method is in harmony with SIPC's Series 500 Rules.

2. The Bankruptcy Court's Decision Frustrates SIPA's Legislative Purpose

"[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says." *Connecticut Nat'l Bank v. Germain*, 503 U.S.

249, 253-54 (1992). Nonetheless, if statutory language is ambiguous, “[l]egislative history and other tools of interpretation may be relied upon.” *Lee v. Bankers Trust Co.*, 166 F.3d 540, 544 (2d Cir. 1999).

SIPA is a remedial statute enacted to “promot[e] investor confidence and provid[e] protection to investors.” *New Times I*, 371 F.3d 68, 84 (2d Cir. 2004). Courts construe SIPA broadly to effectuate these remedial purposes. *Id.* (“These statutory goals . . . are better served by the SEC’s broader reading of section 9(a)(1) [§ 78fff-3].”). Consistent with promoting investor confidence, this Court had noted that “[i]t is a customer’s *legitimate expectations* on the filing date . . . that determines the availability, nature, and extent of customer relief under SIPA.” *New Times II*, 463 F.3d 125, 128 (2d Cir. 2006).

The Net Investment Method frustrates SIPA’s legislative purpose because it undermines customers’ legitimate expectations.

a. Congress Passed SIPA in 1970 to Serve as a Backstop When SEC Regulation Fails to Prevent Fraud

SIPA was enacted in 1970 in the wake of several brokerage failures and rampant fraud in the brokerage industry.²² “The late 1960’s saw the collapse of

²² SIPA’s legislative history indicates that in passing SIPA, Congress had in mind the 1960s “salad oil swindle,” in which brokerage firm Ira Haupt & Co. sold investors worthless notes. *See Securities Investor Protection: Hearings Before the Subcomm. on Commerce & Finance of the House Committee on Interstate & Foreign Commerce, 91st Cong. 91-67 at 1 (1970) (A-III:215) (testimony of Hon.*

several brokerage establishments, causing serious financial losses to their clients. . . . There was considerable concern that investors, particularly smaller ones, would lose confidence in the stability of broker-dealers, and withdraw from the securities market.” *SEC v. F.O. Baroff Co.*, 497 F.2d 280, 283 (2d Cir. 1974).

Although the events of that time have been characterized as a “back office crisis,” that term has been described as a “misnomer”:

Limited capacity translated into back office failure only for firms that had voluntarily overburdened their processing machinery by accepting orders they were unable to process. . . . *In any industry, accepting orders that cannot be filled violates basic principles of contract.* Moreover, in the view of the SEC, such conduct constituted securities fraud. . . .

Put bluntly, the immediate cause of the swamping of back offices was not technological backwardness, but *rampant securities fraud*. The chaos caused by back office failure also created the opportunity for other forms of securities fraud, *including misappropriation*.

Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. Cal. L. Rev. 1071, 1083-84 (1999) (emphasis added).

John E. Moss) (“Public investors are entitled to guaranteed protection against loss from a broker-dealer’s financial mismanagement or insolvency. . . . Public concern was sharply focused on this subject in 1963 with the announcement of the bankruptcy of Ira Haupt & Co., a New York Stock Exchange firm.”); *see also* H.R. Rep. No. 91-1613, at 3 (1970) (A-III:173) (“In the wake of the collapse of Ira Haupt & Co., a New York Stock Exchange member firm, that Exchange established 1964 trust fund to protect customers of its member firms.”).

In the aftermath of these problems, Congress passed SIPA with a twofold purpose: (1) “It will establish immediately a substantial reserve fund which will provide protection to customers of broker-dealers [to] reinforce the confidence that investors have in the U.S. securities markets;” and (2) “the reported bill would provide for a strengthening of the financial responsibilities of broker dealers.” H.R. Rep. No. 91-1613, at 3-4 (1970) (A-III:173-74).

In furtherance of the latter purpose, Congress granted the SEC “rulemaking power with respect to financial responsibility and related practices of brokers and dealers.” *Id.* at 23 (A-III:193); *see also* Pub. L. No. 91-598, 84 Stat. 1636 § 7(d) (1970) (codified at 15 U.S.C. § 78o(c)(3)). The SEC, in turn, promulgated the customer protection rule, which “prevent[s] [misuse of customer monies] by requiring that the broker-dealer keep a separate bank account for the benefit of customers,” *Upton v. SEC*, 75 F.3d 92, 93 (2d Cir. 1996), and the “net capital rule,” which requires broker-dealers to have sufficient liquid assets to satisfy customer and creditor claims. *See* 17 C.F.R. § 240.15c3-3(e); 17 C.F.R. § 240.15c3-1.

This “regulatory framework -- including the net capital and customer protection rules -- serves as the *primary means* of customer protection while SIPC serves in a back-up role.” U.S. General Accounting Office, *Securities Investor Protection: The Regulatory Framework Has Minimized SIPC’s Losses* (Sept.

1992) at 22 (emphasis added) (A-III:244); *see also* H.R. Rep. No. 95-595, at *267 (1977) (A-III:220) (“[SIPA is] premised on the presumption that . . . SEC regulation will insure that proper books and records exist and that property has been properly segregated”).

As described by the SEC Inspector General, the SEC failed to fulfill its regulatory role with regard to Madoff. *See* SEC Office of Inspector General, Executive Summary: Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme (Aug. 31, 2009) (“SEC Executive Summary”) (A-II:582). As SIPA is intended to serve as a backstop to protect customers against such regulatory failures, SIPC necessarily protects against losses proper regulation would have prevented.

b. Congress Authorizes the Automation of the Securities Markets and Amends SIPA to Promote the Immobilization of Securities

In previous decades, investors generally received paper stock certificates evidencing stock ownership, but, as discussed above, this practice posed administrative and logistical problems often resulting in error and delays. To address these problems, in 1975 Congress directed the SEC to establish a national automated securities market. 15 U.S.C. § 78k-1(a)(2). “Since then, it has become

United States government policy to encourage custodial ownership to facilitate clearing and settlement of securities trades.”²³

However, when investors rely on brokerage account statements, rather than receiving stock certificates, they have no independent verification that the broker-dealer actually purchased securities on their behalf. To address this concern, Congress increased SIPA’s recovery limits in 1980. *See* Pub. L. No. 96-433, 94 Stat. 1855 (1980) (increasing SIPA’s limits of protection for securities positions from \$100,000 to the current limit of \$500,000). In recommending this increase, Congress noted that “the increased coverage for securities (including cash) would encourage customers to maintain their securities with broker-dealers, thus promoting the immobilization of stock certificates, which was one of the objectives of the Securities Acts Amendments of 1975.” H.R. Rep. No. 96-1321, at *2 (1980) (A-III:342). The SEC’s website advertises this protection as follows:

Q: How are my securities protected if I choose street name ownership?

A: Nearly all broker-dealers are members of Securities Investor Protection Corporation (“SIPC”). As a result your securities and money held at your broker-dealer are protected up to \$500,000 with a \$100,000 limit for cash.

²³ Marcel Kahn & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 *Geo. L.J.* 1227, 1237 (2008).

“Holding Your Securities -- Get the Facts,” SEC website, www.sec.gov/investor/pubs/holdsec.htm (last visited on Aug. 9, 2010). Here, Appellants are seeking precisely the protection promised by the SEC.

Had BLMIS’s customers requested actual stock certificates, BLMIS would not have been able to perpetrate the fraud. The Net Investment Method penalizes customers for relying on brokerage account statements, encouraging them to revert to the decades-ago practice of requesting actual stock certificates. *New Times I*, 371 F.3d at 87 (noting that “greater investor vigilance, however, is not emphasized in the legislative history of SIPA”).

Because Congress increased SIPA’s limits to encourage customers to rely on their brokerage account statements as verification of their securities holdings, Congress necessarily intended SIPA to protect the reasonable expectations of customers based on their account statements.

c. Congress Amended SIPA in 1978 to Allow Trustees to Purchase Missing Securities, Underscoring that SIPA Protects Customers Even Where Securities Were Never Purchased

In 1978, Congress amended SIPA to add Section 78fff-2(d), which requires a trustee to “purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims for net equities . . . in order to restore the accounts of such customers as of the filing date.” § 78fff-2(d). This provision

enables a trustee to purchase securities for customers whose securities are missing to protect customers' reasonable expectations. *Id.*

The legislative history relating to this provision confirms that Congress intended that trustees would purchase missing securities or provide their cash equivalent to customers, even where securities were never purchased:

A customer generally expects to receive *what he believes is in his account* at the time the stockbroker ceases business. But because securities may have been lost, improperly hypothecated, misappropriated, *never purchased*, or even stolen, it is not always possible to provide to customers that which they expect to receive, that is, securities which they maintained in their brokerage account. . . . By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments . . . would satisfy customers' legitimate expectations

H.R. Rep. No. 95-746, at 21 (1977) (emphasis added) (A-I:617); S. Rep. No. 95-763, at *2 (1978) (A-III:326) (same).

By empowering the trustee to purchase securities for customers where the broker-dealer failed to do so, Congress further emphasized that SIPA protects reasonable customer expectations as reflected on customer statements.

d. In 1988, SIPC Promulgated the Series 500 Rules, Which Emphasize Customer Statements In the Claims Process

As discussed above, in 1988, SIPC promulgated the Series 500 Rules, which govern whether a customer has a claim for cash or a claim for securities. Rule

502(a) provides that a customer has a claim for securities “[w]here the Debtor held cash in an account for a customer [and] the Debtor has sent *written confirmation* to the customer that the securities in question have been purchased for or sold to the customer’s account.” 17 C.F.R. § 300.502(a) (emphasis added).

In promulgating these Rules, SIPC and the SEC determined that customer account statements provide an “objective standard for determining each claimant’s legitimate expectations.” Rules of the Securities Investor Protection Corporation, 53 Fed. Reg. 10368 (Mar. 31, 1988) (codified at 17 C.F.R. §§ 300.501, 300.502). Yet, the Net Investment Method completely disregards customer account statements, looking instead solely to the debtor’s secret “books and records.” Given that the Appellants have never seen Madoff’s secret “books and records,” they cannot form the basis for determining Appellants’ legitimate expectations.

Because the Net Investment Method contravenes SIPA’s goal of protecting reasonable customer expectations, the Net Equity Order should be reversed.

F. The Bankruptcy Court Erred in Holding that the Net Investment Method is Supported by the Trustee’s Avoidance Powers

Judge Lifland held that “only the Net Investment Method is consistent with the Trustee’s statutory avoidance powers.” Decision at 23-24 (SPA-29-30). This holding was erroneous. The Net Investment Method actually conflicts with the Trustee’s avoidance powers in that it enables the Trustee to reduce unilaterally

customer claims based on supposedly avoidable transactions when the Trustee has not pled or proven the elements of avoidance and Appellants have not presented their defenses. In this regard, the Net Investment Method operates as a new and unauthorized avoidance power. *See Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 24-25 (2000) (“Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors’ entitlements, but are limited to what the Bankruptcy Code itself provides.”); *Dewsup v. Timm*, 502 U.S. 410, 420 (1992) (“[T]o attribute to Congress the intention to grant a debtor the broad new remedy against allowed claims . . . without the new remedy’s being mentioned somewhere in the Code itself or in the annals of Congress is not plausible, in our view, and is contrary to basic bankruptcy principles.”); *Cf. United States v. Reorganized CF&I Fabricators*, 518 U.S. 213, 229 (1996) (“[C]ategorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority . . .”).

SIPA incorporates the avoidance powers set forth in the Code by providing that “[t]he trustee may recover any property transferred by the debtor . . . to the extent that such transfer is voidable or void under the provisions of Title 11.” § 78fff-2(c)(3). Section 78fff-2(c)(3) reflects that the Trustee must assert avoidance claims within the framework provided by the Code, rather than by altering the

statutory definitions governing the claims process. A customer is deemed a “creditor” as to any amounts avoided. § 78fff-2(c)(3).

The Code delineates the Trustee’s avoidance powers with statutorily-mandated elements, defenses, and “look back” periods. A review of these provisions demonstrates that avoidance cannot be accomplished through application of the Net Investment Method on a mass basis to avoid transactions going back decades without any proof.

1. The Trustee Has the Burden of Proving All Elements of Avoidance as to Each Challenged Transaction In An Adversary Proceeding

Section 550(a) authorizes the trustee to recover property for the benefit of the estate, to the extent that a transfer is avoidable under Sections 547, 548, 544, and other provisions not likely applicable to this case. *See* 11 U.S.C. § 550(a).

- Section 547(b) “Preferences” This provision permits a trustee to avoid a “preference,” which is a transfer of the debtor’s property, when insolvent, to a creditor, for an antecedent debt, made within 90 days prior to the filing of the petition, enabling the creditor to obtain more than it would otherwise receive. *See* 11 U.S.C. § 547(b).
- Section 548(a) Fraudulent Transfers This provision permits a trustee to avoid a transfer made within a two-year “look back” period, if there was “an actual intent to hinder, delay, or defraud” creditors. 11 U.S.C. § 548(a)(1)(A). Alternatively, a trustee may avoid constructively fraudulent transfers made within a two-year “look back” period if the debtor received less than reasonably equivalent value in exchange for the transfer and the debtor was insolvent at the time of the transfer. 11 U.S.C. § 548(a)(1)(B).
- Section 544(b) State Law Fraudulent Transfers This provision permits the Trustee to avoid transfers under state fraudulent conveyance laws. 11 U.S.C. § 544(b). New York’s fraudulent conveyance statute has a six-year

“look back” period and requires that “the Trustee must establish both the debtor’s and the transferee’s actual fraudulent intent.” *Picard v. Taylor (In re Park S. Secs., LLC)*, 326 B.R. 505, 517 (Bankr. S.D.N.Y. 2005) (dismissing avoidance action because trustee could not prove transferee’s intent); *see also* N.Y. Debt. & Cred. Law § 276. Alternatively, a trustee may avoid a constructively fraudulent transfer made “without fair consideration” when the person making the transfer is in various states of financial distress. N.Y. Debt. & Cred. Law §§ 273, 274, 275.

“The burden of proof to establish each of the[] elements [of an avoidance action] by a preponderance of the evidence rests on the trustee in bankruptcy.” *Cadle Co. v. Mangan (In re Flanagan)*, 503 F.3d 171, 180 (2d Cir. 2007); *see also* Collier on Bankruptcy § 548.11 (15th ed.) (“The burden of proof of establishing the existence of the elements of a voidable transfer under section 548 of the Bankruptcy Code rests on the trustee.”). Moreover, avoidance actions are to be litigated in the context of an adversary proceeding. *See* Fed. R. Bankr. P. 7001; Collier on Bankruptcy § 548.04[2][c] (15th ed.) (“A fraudulent transfer avoidance action in the context of a bankruptcy case requires the initiation of an adversary proceeding pursuant to Bankruptcy Rule 7001.”).

Appellants acknowledge that Section 502(d) provides that “the court shall disallow any claim of any entity from which property is recoverable under [the Code’s avoidance provisions].” 11 U.S.C. § 502(d). However, the Trustee has not alleged any avoidable transfers as against the Appellants. Moreover, Section 502(d) is essentially a collection device “designed to be triggered *after* a creditor has been afforded a reasonable time in which to turn over amounts *adjudicated to*

belong to the bankruptcy estate.” In re Davis, 889 F.2d 658, 662 (5th Cir. 1989) (emphasis added). In other words, Section 502(d) requires a trustee to *prove* the elements of an avoidance action to be decided by the bankruptcy court *before* a Trustee can disallow claims under Section 502(d). *See Holloway v. IRS (In re Odom Antennas, Inc.)*, 340 F.3d 705, 708 (8th Cir. 2003) (holding that 502(d) disallowance is proper “after the entity is first adjudged liable”); *Seta Corp. v. Atlantic Computer Sys. (In re Atlantic Computer Sys.)*, 173 B.R. 858, 862 (S.D.N.Y. 1994) (holding that Section 502(d) “clearly envisions some sort of determination of the claimant’s liability before its claims are disallowed”); *In re Riverwood La Place Assocs., LLC*, 234 B.R. 256, 259-60 (Bankr. E.D.N.Y. 1999) (rejecting trustee’s Section 502(d) disallowance as improper because “[a] fraudulent conveyance cannot be recovered through a motion Basic bankruptcy practice recognizes that to recover money or property, an adversary proceeding must be commenced.”).

Even in the context of a Ponzi scheme, each challenged transaction must be analyzed individually. *See Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 490 (D. Conn. 2002) (holding in context of Ponzi scheme that “proper focus of a fraudulent transfer inquiry is on the transfer itself, not on the overall business practices of the Debtor.”); *In re Image Masters, Inc.*, 421 B.R. 164, 186 (Bankr. E.D. Pa. 2009) (holding that trustee must “set forth factual allegations of

fraudulent intent in connection with the specific transfer sought to be avoided” because “the general fraudulent intent underlying the Ponzi scheme was insufficient to establish the fraudulent transfer cause of action”); *Balaber-Strauss v. Lawrence*, 264 B.R. 303, 308 (S.D.N.Y. 2001) (“[T]he law does not require the Court to assess the transactions’ impact on the Debtor’s overall business [which was a Ponzi scheme]. The law requires that the Court evaluate the ‘specific consideration exchanged by the debtor and the transferee in the specific transaction which the trustee seeks to avoid’”) (citation omitted).

Application of the Net Investment Method is further improper because the Trustee has not established when the fraud began or when BLMIS became insolvent. *See Universal Church v. Geltzer*, 463 F.3d 218, 226 (2d Cir. 2006) (“In order to avoid the contributions . . . , [the trustee] had to establish that [the debtor] was insolvent at the time the contributions were made. [I]nsolvency is determined by . . . whether the debtor’s assets were exceeded by her liabilities at the time of the transfer.”) (internal citations omitted).

Moreover, the Trustee must demonstrate that any challenged transactions were not paid out of monies earned by BLMIS’s “legitimate” and “profitable” market making and propriety trading businesses. *See Carrozzella & Richardson*, 286 B.R. at 491 (“[T]here has been no proof that the monies these particular Defendants received from the [debtor’s] ‘pot’ of common funds were investment

funds deposited by other investors as opposed to law firm revenues [derived from] income from a legitimate law practice.”).

2. The Net Investment Method Wrongfully Deprives the Appellants of Their Right to Present Defenses to Any Avoidance Claims

Not only does the Net Investment Method improperly allow the Trustee to avoid transactions without proving the necessary elements of avoidance, it likewise wrongfully prevents Appellants from the opportunity to present their defenses, which could include, among others:

- “reasonably equivalent value” under 11 U.S.C. Section 548(a)(1)(B);
- “for value and in good faith”²⁴ under 11 U.S.C. Section 548(c);
- the “safe harbor” provision for settlement payments made in connection with a securities contract as set forth in 11 U.S.C. Section 546(e);
- “fair consideration” under N.Y. Debt. & Cred. Law Section 272;
- the Trustee’s failure to demonstrate actual fraudulent intent by the Appellants under N.Y. Debt. & Cred. Law Section 276.

Numerous cases hold that defenses are applicable to a trustee’s avoidance action, notwithstanding the existence of a Ponzi scheme. For example, in *In re Unified Commercial Capital, Inc.*, the court dismissed a bankruptcy trustee’s

²⁴ The SEC has acknowledged that Madoff’s use of the Appellants’ money over the years had “value.” See SEC Brief [Bankr. Dkt. No. 1052] (urging that the Trustee should calculate customer claims to include a rate of interest sufficient to account for the time value of customers’ monies deposited with BLMIS).

avoidance action seeking to recover interest payments made to innocent Ponzi scheme investors. *See Lustig v. Weisz & Assocs., Inc. (In re Unified Commercial Capital, Inc.)*, 260 B.R. 343, 345-46 (Bankr. W.D.N.Y. 2001). The court held that the “fictional” interest was paid to the investors for equivalent value -- namely, the use of their money:

Although I do not condone “Ponzi” schemes, I do not understand why courts have found them to be so different from the many other fraudulent schemes seen in bankruptcy cases where innocent individuals lose money, that they are willing, in the name of public policy, to do what I consider to be such an injustice to the fraudulent conveyance statutes by ignoring the universally accepted fundamental commercial principal that, when you loan an entity money for a period of time in good faith, you have given value and are entitled to a reasonable return. Although many courts that have decided this issue seem to believe that it is more “just” to require that an innocent investor victim who received reasonable contractual interest return it so that it can be redistributed among the investors who did not recover all of their principal, I do not believe that partial solution is more “fair” or “just” than allowing that victim to keep the interest. Furthermore, I believe that the majority of the general public would agree that allowing those victims to keep their interest is as fair or even a more fair solution.

Id. at 351.

Other courts have followed this approach. *See In re Image Masters, Inc.*, 421 B.R. 164, 181 (Bankr. E.D. Pa. 2009) (holding that Ponzi scheme victims received transfers in good faith where they “were not part of or aware of the artifice and scheme” and “were also actual victims of the Ponzi scheme”); *Daly v.*

Deptula (In re Carrozzella & Richardson), 286 B.R. 480, 490-91 (D. Conn. 2002) (“There is nothing in the statute to support a finding that the Debtor did not receive ‘reasonably equivalent value’ . . . simply because the Debtor was engaged in a Ponzi scheme.”); *Breeden v. Thomas (In re Bennett Funding Group, Inc.)*, No. 98-61376, 1999 Bankr. LEXIS 1843, at *37-38 (Bankr. N.D.N.Y. Apr. 29, 1999) (“[T]he Trustee argues that it is simply inequitable to allow Defendant to keep his payments when other equally innocent investors lost most or all of their money. [H]owever, the payments to Defendant cannot be avoided under Code § 548 without doing violence to the language and structure of the Bankruptcy Code.”); *Johnson v. Studholme*, 619 F. Supp. 1347, 1350 (D. Colo. 1985) (“Some investors who received ‘fictitious profits’ may have spent the money on education or other necessities many years ago. What else in equity and good conscience should plaintiffs who received money in good faith pursuant to an ‘investment contract’ have done?”) *aff’d sub nom., Johnson v. Hendricks*, 833 F.2d 908 (10th Cir. 1987); *see also Orlick v. Kozyak (In re Fin. Federated Title & Trust, Inc.)*, 309 F.3d 1325, 1332-33 (11th Cir. 2002) (“[T]he district court and the bankruptcy court erred in . . . determining that [recipient of funds from Ponzi scheme] was barred as a matter of law [from] asserting her affirmative defense under Section 548(c) of ‘for value and in good faith.’”).²⁵

²⁵ As described in a non-bankruptcy context in another case involving a Ponzi

Because the Net Investment Method would avoid all transactions in excess of the Appellants' principal without permitting Appellants the opportunity to raise defenses as to each transaction sought to be avoided, the Bankruptcy Court's Decision should be reversed.

scheme:

Plaintiffs gave \$21 million to Gruttadauria, *not to hide under a rock or lock in a safe, but for the express purpose of investment, with a hope -- indeed a reasonable expectation -- that it would grow. Thus, the out-of-pocket theory, which seeks to restore to Plaintiffs only the \$21 million they originally invested less their subsequent withdrawals, is a wholly inadequate measure of damages.* Had Gruttadauria invested Plaintiffs' money as requested, their funds would have likely grown immensely, especially considering that Plaintiffs invested primarily throughout the mid-1990s, which . . . would have placed their money in the stock market during one of the strongest bull markets in recent memory. In fact, the fictitious statements issued by Lehman, which were designed to track Plaintiffs' funds as if they had been properly invested, indicate that Plaintiffs' accounts would have grown to more than \$ 37.9 million (even accounting for the withdrawal of more than \$31.3 million). Plaintiffs thus could have reasonably believed that they were entitled to the full \$37.9 million balance shown, regardless of the amounts of their previous deposits and withdrawals. We therefore reject Lehman's argument because it is founded on an improper -- and wholly inadequate -- measure of damages.

Visconsi v. Lehman Bros., 244 Fed. Appx. 708, 713-14 (6th Cir. 2007) (emphasis added); *see also SEC v. Byers*, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009) (approving equitable distribution in Ponzi scheme liquidation allowing victims to claim "illusory" profits that were reinvested) (Chin, J.).

3. The Statutory “Look Back” Periods Applicable to Avoidance Actions Preclude Application of the Net Investment Method

Judge Lifland erred in approving the Trustee’s Net Investment Method because it avoids transfers and obligations beyond the statutory “look back” provisions applicable to avoidance actions.

Section 548(a)(1) provides that a trustee may avoid a fraudulent transfer “that was made or incurred on or *within 2 years before the date of the filing* of the petition” provided certain criteria are fulfilled. 11 U.S.C. § 548(a)(1) (emphasis added). To the extent the Trustee seeks to avoid fraudulent transfers based on state law, he is limited to pursuing fraudulent transfers made *within six years of the filing date*. See 11 U.S.C. § 544(b); N.Y.C.P.L.R. § 213(1). Based on these statutory “look back” periods, in no event can the Trustee avoid any transactions occurring before December 11, 2002. Importantly, these “look back” periods are distinct from the two-year period in which a trustee must *commence* an avoidance action. See 11 U.S.C. § 546(a).

The Trustee argued below that an “avoidance action outside [the] statute of limitations can serve as [a] defense to payment of [a] claim under section 502(d).” See Trustee Reply Br. at 14 n.9 [Bankr. Dkt. No. 1773]. However, Section 502(d) merely enables a trustee to “raise avoidance actions as a defense to claims . . . even if . . . time-barred from *commencing* an avoidance action under section 546(a),” it

does not permit the Trustee to disallow claims based on transactions beyond the statutory “look back” periods for avoidance. Collier on Bankruptcy § 546.02[1][d] (15th ed.) (discussing that under 11 U.S.C. Section 546(a) a trustee has two years from the filing date to *commence* an avoidance action). Any transactions occurring beyond the statutory “look back” periods are not avoidable, and thus cannot form the basis of a Section 502(d) disallowance.

As most of the Appellants became customers of BLMIS in the early 1990s, they began accruing purported earnings well before December 11, 2002. Because the Net Investment Method operates to avoid transactions beyond the statutory “look back” provisions, the Net Equity Order should be reversed.²⁶

G. The Bankruptcy Court Erred in Deviating From the Applicable Statutes in the Name of “Equity,” and In Any Event, the Net Investment Method Is Not Equitable

The Bankruptcy Court ruled that “equity dictates that the Court implement the Net Investment Method.” Decision at 31 (SPA-37). However, “whatever equitable powers remain in the bankruptcy courts must and can only be exercised

²⁶ In addition, while courts permit “defensive” use of Section 502(d) to disallow claims where the claimant has received avoidable “transfers,” it does not allow for “defensive” avoidance of “obligations.” *See In re Asia Global Crossing, Ltd.*, 333 B.R. 199, 202 (Bankr. S.D.N.Y. 2005) (“Section 502(d) is not . . . coextensive with the avoidance provisions available to the trustee.”); *see also In re Revco D.S.*, No. 88-1308, 1990 Bankr. LEXIS 2966, at *67 (Bankr. D. Ohio Dec. 17, 1990) (“Section 502(d) limits its application, however, to a fraudulent transfer, while omitting any reference to incurrence of an avoidable obligation.”).

within the confines of the Bankruptcy Code.” *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988); *see also Marrama v. Citizens Bank*, 549 U.S. 365, 383 (2007) (“Whatever steps a bankruptcy court may take pursuant to § 105(a) or its general equitable powers, a bankruptcy court cannot contravene the provisions of the Code.”).

To justify its adoption of the Net Investment Method, the Bankruptcy Court described the purported unfairness of allowing BLMIS customers who have withdrawn monies over the years to recover additional amounts under SIPA, while new investors who made no withdrawals would be limited to recovering an amount up to the \$500,000 SIPC advance and potentially a pro rata share of customer property. Decision at 32 (SPA-38). However, the Bankruptcy Court failed to note that those BLMIS customers who have made withdrawals over the years, who will supposedly unfairly benefit under the Last Statement Method, have paid years of taxes on the earnings reported on their account statements, offsetting any purported “unfairness.” For elderly investors whose IRAs were controlled by Madoff, many such withdrawals were mandatory. *See* 26 C.F.R. § 1.408-2(b)(6) (requiring individual retirement account holder to receive mandatory distributions upon turning 70 ½). For these people, the Net Investment Method does not provide “equity.”

Furthermore, the Net Investment Method results in a claim denial for over half of Madoff's customers, and exposes a significant number to avoidance actions. *See* Transcript of Interview With Trustee (A-II:124-25) (explaining that he will deny the claims of more than half of Madoff's victims); Michael Rothfeld, *Madoff Investors Brace for Lawsuits*, WALL STREET JOURNAL, July 26, 2010, at C1 (“[I]rving Picard said he could wind up suing about half the estimated 2,000 individual investors he has called ‘net winners’ from their dealings with Mr. Madoff.”). The Court should be skeptical of an approach that significantly minimizes customer recoveries. *SEC v. Byers*, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009) (rejecting claims calculation methodology in receivership that “would mean that 45% of investors would receive no distribution”).

Other courts have questioned the equities of subjecting innocent customers to avoidance actions:

[I]t is not clear that restitution is appropriate between the innocent investors who lost money and innocent investors who obtained fictitious profits. Here, the mistake of all investors was to trust [the fraudster]. Whether general principles of equity require that completely innocent investors in a Ponzi scheme should be required to share in the losses with, or be divested of “profits” for the benefit of persons whom they have never met or dealt with is not an easy question.

Some investors who received “fictitious profits” may have spent the money on education or other necessities many years ago. What else in equity and good conscience should plaintiffs who received money in good

faith pursuant to an “investment contract” have done? In contrast, some investors who lost money may have been speculators who were prepared to lose their investments. There is simply no neat answer to the various equities involved here where the investors never knew each other and were equally at fault for trusting [the fraudster].

Johnson v. Studholme, 619 F. Supp. 1347, 1350 (D. Col. 1985), *aff'd Johnson v. Hendricks*, 833 F.2d 908 (10th Cir. 1987); *see also Byers*, 637 F. Supp. 2d at 182 (“Many of the investors may not have the money, and litigation to collect it would be expensive, time-consuming, and, in some instances, cruel.”).

No customer stands to gain a windfall under the Last Statement Method. At best, some customers will recover from SIPC what they thought they already owned, while others -- those whose BLMIS statements showed investments in excess of SIPC’s \$500,000 limit -- may receive only their SIPC advance and a minute share of customer property. In this regard, the Last Statement Method is the most equitable in that it protects the most people from the harshest result -- total loss of what was thought to be life savings. In contrast, the Net Investment Method reduces recoveries, and not coincidentally, minimizes SIPC’s exposure.

To obtain “perfect justice,” all BLMIS investors would have to return all of their monies to the estate so it could be redistributed with exactitude. Such a result is not practical, possible, or supported by SIPA or the Code.

VIII. CONCLUSION

Based on the foregoing, Appellants respectfully request that the Court reverse the Net Equity Order (SPA-60).

Additionally, Appellants note that the Bankruptcy Court specifically limited the issues briefed below to the Last Statement Method versus the Net Investment Method, reserving all other claims calculation issues, including alternative claims calculation methodologies, for a later date. *See* Order Scheduling Adjudication of “Net Equity” Issue (Sept. 16, 2009) (A-I:264); Letter Endorsement (Sept. 16, 2009) [Bankr. Dkt. No. 438]. As such, Appellants respectfully request that, in the event the Court affirms the Net Equity Order, any such decision should not preclude Appellants from raising arguments below regarding claims calculation issues not yet before this Court or the Bankruptcy Court, such as whether Appellants could recover interest on their principal contributions to BLMIS if the Net Investment Method applied.

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ADDENDUM A**Appellants Represented by Milberg LLP/Seeger Weiss LLP²⁷**

Customer Name	Last Statement Method	Net Investment Method
The Aspen Company Claim No. 09528 Objection [Bankr. Dkt. No. 452]	\$3,540,073.79	\$(1,957,000.00)
Ann Denver Claim No. 0970 Objection [Bankr. Dkt. No. 409]	\$6,825,990.38	\$1,303,000.00
Norton Eisenberg (IRA) Claim No. 08937 Objection [Bankr. Dkt. No. 435]	\$8,274,567.12	\$(1,653,823.46)
Export Technicians Inc. Claim Nos. 005351, 014260 Objection [Bankr. Dkt. No. 436]	\$668,502.56	\$40,000.00
Stephen R. Goldenberg Claim No. 010950 Objection [Bankr. Dkt. No. 460]	\$6,236,401.86	\$(4,000,000.00)
Judith Rock Goldman (IRA) Claim No. 009794 Objection [Bankr. Dkt. No. 396]	\$213,899.91	\$49,378.00
Albert J. Goldstein U/W FBO Ruth E. Goldstein Claim No. 009316 Objection [Bankr. Dkt. No. 398]	\$1,980,527.93	\$326,000.00

²⁷ Appellants Michael and Stacy Mathias are not included in this Addendum because they were not identified in the Trustee's motion below. However, because they nonetheless opposed the Trustee's motion below, they were included on the Bankruptcy's Court's service list for the Net Equity Order, and as such, they are included as Appellants.

Customer Name	Last Statement Method	Net Investment Method
Jerry Guberman (IRA) Claim Nos. 01630, 010171 Objection [Bankr. Dkt. No. 382]	\$464,187.65	\$61,793.39
Anita Karimian (IRA) Claim No. 010930 Objection [Bankr. Dkt. No. 397]	\$127,479.33	\$21,532.43
Martin Rappaport Claim No. 006125 Objection [Bankr. Dkt. No. 259]	\$20,838,043.73	\$12,600,000.00
Paul J. Robinson Claim Nos. 000429 & 014257 Objection [Bankr. Dkt. No. 371]	\$4,611,466.00	\$80,000.00
Bernard Seldon (IRA) Claim No. 006615 Objection [Bankr. Dkt. No. 453]	1,169,784.50	(\$1,159,409.73)
Harold A. Thau Claim No. 09522 Objection [Bankr. Dkt. No. 450]	\$8,261,799.37	\$(3,281,000.00)

Appellants Represented by Lax & Neville, LLP

Customer Name	Last Statement Method	Net Investment Method
Mary Albanese (IRA) Claim No. 002227 Objection [Bankr. Dkt. No. 734]	\$858,065.72	(\$184,092.55)
The Brow Family Partnership Claim No. 13499 Objection [Bankr. Dkt. No. 2282]	\$830,753.18	(\$866,858.90)
Gordon Bennett 1988 Trust Claim No. 13917 Objection [Bankr. Dkt. No. 466]	\$1,769,388.69	(\$1,573,103.86)

Customer Name	Last Statement Method	Net Investment Method
Allan Goldstein (IRA) Claim No. 008197 Objection [Bankr. Dkt. No. 404]	\$4,250,725.14	\$320,404.52
Laurence Kaye (IRA) Claim No. 008400 Objection [Bankr. Dkt. No. 374]	\$531,692.94	\$139,853.68
Laurence Kaye & Susan Kaye Trustees Claim No. 009106 Objection [Bankr. Dkt. No. 2813]	\$1,284,610.08	(\$714,500.00)
Rose Less Claim No. 2402 Objection [Bankr. Dkt. No. 713]	\$797,352.89	(\$343,242.04)
Watershed Foundation, Gordon Bennett as Trustee Claim No. 013913 Objection [Bankr. Dkt. No. 1015]	\$272,863.95	\$54,000.00

**CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME
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This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B), because this brief contains 13,253 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

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I, _____, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at the address shown above or at

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