

LEGAL UPDATE

January 2009 *By: Richard Levy, Jr.*

CONSIDERATIONS RELATING TO THE BERNARD MADOFF SECURITIES FRAUD

BACKGROUND

The United States Justice Department and the Securities and Exchange Commission commenced civil and criminal proceedings in December 2008 against Bernard L. Madoff (a former chairman of the board of NASDAQ) and his securities firm, Bernard L. Madoff Investment Securities, Inc. (collectively, "Madoff"), arising from an alleged Ponzi-scheme. The magnitude of the fraud alleged to have been perpetrated by Mr. Madoff and his business has been reported to exceed \$50 billion.

On December 11, 2008, the SEC filed a complaint in the U.S. District Court for the Southern District of New York seeking the liquidation of the Madoff securities business pursuant to the Securities Investors Protection Act ("SIPA"). On December 15, 2008, that Court ordered the case to proceed as a SIPA liquidation in the U.S. Bankruptcy Court for the Southern District of New York ("Bankruptcy Court").

The liquidation proceedings are now pending in the Bankruptcy Court before Judge Burton R. Lifland, under Case No. 08-01789 (BRL). Irving Picard, Esq., a New York bankruptcy attorney, has been appointed as the SIPA trustee to oversee the liquidation proceedings. The SIPA case will provide a forum for aggrieved investors to submit proofs of claim, and thereby to share ratably in any recovery that the trustee may realize for the benefit of the firm's customers. There is, however, also an expectation that the SIPA trustee will commence proceedings against investors who received distributions or redemptions from the firm within relevant statutory periods, on the theory that such payments are subject to disgorgement as either fraudulent conveyances or unlawful distributions (under federal bankruptcy law and applicable New York state law, which could reach payments made as long as 6 years before the commencement of the

liquidation case) or as preferences (under federal bankruptcy law, which affects payments made within 90 days before commencement of the bankruptcy proceeding).

SUMMARY OF IMPORTANT CONSIDERATIONS CONCERNING THE MADOFF LIQUIDATION PROCEEDING:

- A. The Madoff liquidation will not be a quick process.** The liquidation proceeding will be complicated, in terms of verification of the assets and liabilities of the securities business, verification of the status of customers and the amount and nature of their claims, the form in which distributions may be made (securities and/or cash), and the collection of other assets for distribution to claimants. The SIPA trustee is reported to have mailed notices and claim forms to more than 8,000 persons who are reflected in Madoff's records as having had customer accounts with, or having been creditors of, the firm during the year prior to the commencement of the case. Among his other statutory responsibilities, the SIPA trustee is responsible to review all claims and determine their eligibility for recovery of each claim to share in the SIPA recovery process. Claims likely will be filed by persons who may hold claims or debts from prior time periods.
- B.** The pending liquidation proceeding is designed to level the playing field so that no interested party gets an advantage over others. There may be alternative routes of recovery open to clients, but the assembly and maintenance of information will be important to any of the affected investors' rights and options.
- C. Affected parties should collect and maintain all relevant information and documents relating to the Madoff situation,** including account statements, evidence of investments

made with Madoff, payments or distributions received from Madoff, communications to and from Madoff, etc., and copies of any other documents received from or sent to Madoff.

- D. There is no reason to contemplate the commencement of any action or proceeding against Madoff. As a practical matter, the commencement of the SIPA liquidation proceeding operates as a statutory stay against the pursuit of such relief without prior leave of the Bankruptcy Court.
- E. Persons or institutions whose investments through Madoff were made through or in reliance on third parties (i.e., broker-dealers, fund managers, feeder funds, accountants, etc.) may have independent rights or claims against those parties (or others) relating to the Madoff investments.
- F. As noted above, **investors who received distributions or payments from Madoff may be named in lawsuits by the SIPA trustee to seek recovery of those distributions or payments for the bankruptcy estate**, in which case the recovered proceeds would become part of the assets available for distribution to eligible customers and claimants.
- G. **Some losses may be entitled to compensation provided by the Securities Investors Protection Corporation (“SIPC”).** SIPC coverage is also limited to \$500,000 per customer, including up to \$100,000 for cash. For purposes of SIPC coverage, customers are persons who have securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions. SIPC, however, does not insure against market risk. Subject to customer limits, SIPC only protects the value of the securities held by the affected broker-dealer as of the time that a SIPA proceeding is commenced. Moreover, SIPC does not protect all investments. In general, SIPC covers notes, stocks, bonds, mutual fund and other investment company shares, and other registered securities. SIPC does not cover instruments such as unregistered investment contracts, unregistered limited partnerships, fixed annuity contracts, currency, and interests in gold, silver, or other commodity futures contracts or commodity options. SIPC protection is provided in the form of cash advances from SIPC to the SIPA trustee in the

liquidation proceeding, for the purpose of satisfying customer net equity claims either through the purchase of securities as may be required to satisfy customer net equity claims or through cash payments, in accordance with the provisions of SIPA and as authorized by the Bankruptcy Court.

- H. In a SIPA liquidation, **customers’ claims for “net equity” (the value of securities and cash in their accounts at Madoff as of the commencement of the case – here, December 11, 2008 – net of amounts owed to the firm at that time for the purchase of securities) are entitled to payment from the pool of “customer property”** (usually the cash and unregistered securities at any time received, acquired by or held by the debtor-broker on account of customers, plus the proceeds of any customer property transferred by the broker or unlawfully converted by the broker). **The customer property pool is not available to satisfy the claims of general creditors of the broker. Thus, customers holding net equity claims, therefore, are preferred creditors of the broker in the sense that they may be compensated ratably for their customer net equity claims from the customer property pool and, to the extent of any deficiency remaining after distributions from that pool, ratably from the broker’s general estate.** (Such recovery is separate from any recovery on claims other than customer net equity claims that the claimant may assert against the debtor which, if allowed, are entitled to ratable distribution from the proceeds of general estate.)
The customer property pool will also include the proceeds of “avoidance” or “clawback” actions that the trustee may commence, as well as the proceeds of certain other business property of the debtor.
- I. **Customers are also entitled to receive their “customer name securities,”** which are securities that were specifically registered or in the process of being registered to the customer as of the commencement of the case, and which were non-negotiable. Those securities are not part of the pool of customer property available for ratable distribution among all holders of customer net equity claims.) **Securities that were held by the broker in street name on**

account of the customer typically will become part of the customer property pool.

J. The Bankruptcy Court has set two bar dates for the filing of claims against the debtor, in accordance with the directives of SIPA. Notice of the bar dates was mailed and published on January 2, 2009. The bar dates are:

- **For customers to obtain the maximum protections afforded by SIPA – compensation from the customer property pool, and the benefits of SIPC advances – their written claims must be received by the SIPA trustee not later than 60 days after the date of publication of the notice.** (The trustee’s notice specifies March 4, 2009 as the deadline; we, however, believe that the actual statutory deadline is March 3, 2009, and we therefore recommend that claims should be sent so as to be received by the trustee by that date.)
- In any event, **customer net equity claims, and proofs of claims by creditors and claimants for any other reason, must be received by the SIPA trustee not later than six months after the date of publication of the notice,** July 2, 2009. Claims received after that date will not be allowed.

Customers may file net equity claims with the SIPA trustee after the initial 60-day deadline, but the SIPA trustee is not required to compensate such claims from the pool of customer property, *i.e.*, such claims may receive less favorable treatment than customer net equity claims filed before the 60-day deadline.

Timely-filed claims may be subject to amendment after the filing deadline but only to the extent that the changes relate back to the transactions and occurrences covered by the original filing. New bases or theories of recovery asserted for the first time in an amended claim may be disallowed.

K. If customer net equity claims that are eligible for compensation from the customer property

pool are not fully satisfied from the available pool of customer property and from the SIPC advances (for those customers who timely file in order to obtain the benefit of the advances), the deficiency of the customer net equity claims will share ratably in the general estate of the debtor along with the claims of allowed general unsecured creditors, after payment of the administrative expenses of the liquidation case.

L. Claims of customers for amounts other than their net equity as of December 11, 2008, such as market losses, fraud, or other damages, and claims of commercial creditors (vendors, landlords, etc.), are *not* compensable from the pool of customer property. Rather, such claims may be asserted only as unsecured claims against the debtor’s general estate and, if allowed, will share ratably with all other allowed general unsecured claims in the proceeds of the general estate.)

M. There may be important tax implications for affected investors. For example, under United States tax law, losses may be eligible for treatment as theft losses that may generate immediate deductions that can be claimed on tax returns for the current tax year. There may also be grounds to reopen and amend returns for several prior tax years.

Pryor Cashman LLP has the capabilities to monitor the SIPA liquidation proceedings and to provide advice and counsel on a range of aspects of the Madoff situation, including: filing of customer net equity claims and other Madoff-related claims; rights and remedies that may be available against third parties; representation of suitors in actions against third parties; issues involving possible exposure to disgorgement actions that may be brought by the SIPA trustee; representation of persons sued in such actions, or who may otherwise be targets of actions by aggrieved investors relating to involvement or connections with Madoff; insurance considerations; and the tax treatment under United States law of losses experienced by investors.

For further information concerning the Madoff situation, please contact any of the following partners at Pryor Cashman LLP:

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Richard Levy, Jr. heads the Bankruptcy, Reorganization and Creditors' Rights practice at Pryor Cashman. His experience includes all phases of cases under Chapter 11 and Chapter 7 of the Bankruptcy Code, bankruptcy litigation, civil litigation in federal and state courts, related counseling, and arbitration and mediation. Rich has represented debtors, creditors, official and unofficial committees (including committees of creditors, equity holders or retired employees), landlords, indenture trustees, labor unions, pension funds, and asset purchasers. He also has represented parties in state court insolvency and corporate dissolution proceedings.

Rich represented the indenture trustees of publicly-traded bonds in the Kmart, Global Crossing, Hayes Lemmerz, Owens Corning, and Quality Stores cases, among others. His experience also includes bankruptcy litigation on behalf of indenture trustees with respect to their contractual rights and obligations under their indentures including, for example, the charging lien litigation commenced by the official creditors committee against the indenture trustee in the Global Crossing case. He regularly supports and assists in the firm's representation of indenture trustees in other bankruptcy cases and default situations.

Rich regularly assists other practice areas of the firm by providing bankruptcy support and counsel in the structuring of business and commercial transactions, including, for example, financings, mergers and acquisitions, securitization transactions requiring non-consolidation or true sale opinions, intellectual property licenses, real estate leases and other executory contracts. He is also called upon to provide advice and representation with respect to the enforcement of judgments and debtor/creditor remedies under state law.

Rich has held special appointments in a number of bankruptcy cases. He served as counsel to the Chapter 11 Trustee appointed by the U.S. Bankruptcy Court for the District of Delaware in the asbestos-related bankruptcy case of United State Mineral Products Company, a leading manufacturer of spray-applied fire resistive materials for steel framed buildings and other structures. The case was one of the first to involve a successful restructuring of both asbestos-related personal injury claims and property damage claims under Section 524(g) of the U.S. Bankruptcy Code, and also is believed to be the first asbestos bankruptcy case to result in a successful reorganization under the auspices of a court-appointed trustee.

Rich has also served as the court-appointed official legal representative of future claimants in two other asbestos bankruptcy cases. He was the court-designated lead counsel in consolidated insolvency litigation proceedings arising from the Chapter 11 bankruptcy of a major airline. He also served as court-appointed examiner and, subsequently, as the post-confirmation creditor trustee in the Chapter 11 case of a well-known entertainer. Rich represented the official representative of retired employees appointed in the bankruptcy case of a metal products manufacturer, and the unofficial retiree committee in the reorganization case of a major meat-packing company. Rich served as a member of the Trust Advisory Board for the HLI Creditor Trust established in connection with the confirmed Chapter 11 bankruptcy plan for Hayes Lemmerz, Inc.

Rich graduated *magna cum laude* from Syracuse University College of Law in 1977, where he was elected to the Order of the Coif and served as Notes & Comments Editor of the Syracuse Law Review (1976-77). A 1974 graduate of Williams College (*cum laude*, with honors in Political Economy), Rich served as President of the Society of Alumni of Williams College – the oldest continuously-existing college or university alumni association in the world – from June 2006 to June 2008. During his term, Rich also chaired the Executive

Committee of the Society of Alumni and attended meetings of the Board of Trustees of Williams College at the invitation of the Board.

Rich is AV Peer Review Rated, Martindale Hubbell's highest peer recognition for ethical standards and legal ability.