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Second Circuit Holds That SIPA Does Not Permit an Inflation or Interest Adjustment to “Net Equity” Claims For Customer Property

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In ***In re Bernard L. Madoff Investment Securities LLC*****,** No. 14-97-bk(L), 2015 WL 727965 (2d Cir. Feb. 20, 2015), the ***United States Court of Appeals for the Second Circuit*** held that no adjustment for inflation or interest could be made under the ***Securities Investor Protection Act***, 15 U.S.C. § 78aaa, *et seq*. (“SIPA”), in calculating “net equity” claims for customer property. The Second Circuit’s opinion re-affirms that SIPA is not intended to shield investors from loss, and that its goal is limited to restoring customers of defunct broker-dealers to the pre-liquidation *status quo*.

Background

In re Bernard L. Madoff arises out of Bernie Madoff’s Ponzi scheme. Claimants-Appellants (“Claimants”), former investors of Bernard L. Madoff Investment Securities LLC (“BLMIS”), deposited money with BLMIS for investment. Madoff, however, never invested the funds. To conceal the lack of trading activity, Madoff created fictitious account statements and trading records, and funded customer withdrawals with the principal investments of new and existing customers. Ultimately, the house of cards that was BLMIS collapsed, defrauding customers out of billions of dollars. After the collapse of BLMIS, Trustee-Appellee, Irving H. Picard (“Trustee”), was appointed as trustee for the liquidation of BLMIS pursuant to SIPA.

SIPA

SIPA prioritizes the distribution of customer property in a broker-dealer liquidation. It creates a fund of customer property, separate from the broker-dealer’s general estate, for priority distribution exclusively among a failed broker-dealer’s customers. Customers share in the fund proportionally, according to each customer’s “net equity.” SIPA defines “net equity” as the dollar amount of a customer’s account which would have been owed by the debtor to the customer had the customer’s positions been liquidated, minus any indebtedness of the customer to the debtor as of the filing date.

Bankruptcy Court's Decision

In an effort to recover funds lost in the collapse of BLMIS, Claimants filed SIPA claims in the United States Bankruptcy Court for the Southern District of New York. Claimants asked the Trustee to adjust their proportional share of customer property to reflect inflation over the life of Madoff's fraud, with one Claimant also seeking an interest adjustment to reflect the time-value of money over that time.

The bankruptcy court, however, upheld the Trustee's determination that SIPA does not permit an adjustment for inflation or interest. The court then certified an immediate appeal of its decision. The Second Circuit granted the petition for direct appeal.

Second Circuit's Decision

On appeal, the Second Circuit affirmed the Bankruptcy Court's order approving the Trustee's unadjusted net equity calculation. The Court made clear that its "holding is limited to a post-liquidation adjustment of customers' net equity calculations. Obviously, if a customer's pre-liquidation account contained earnings from holdings that awarded interest or were protected against inflation, for instance, the customer's claim for net equity would include those earnings . . . ."

In so holding, the Court determined that an inflation or interest adjustment is inconsistent with SIPA's statutory framework. As the Court pointed out, SIPA's definition of net equity makes no mention of inflation, whereas other parts of the statute do. The Court held SIPA's silence on this issue unsurprising, observing that an inflation adjustment under SIPA would be "nonsensical," as securities purchased for a broker-dealer's customers already incorporate economic forces like inflation.

The Court also explained that an inflation adjustment is beyond the scope of SIPA's intended protections. SIPA does not shield investors from loss. Instead, it merely restores investors to their pre-liquidation positions. As such, "avoidance of loss beyond restoration of the pre-failure status quo is not SIPA's goal," and in a SIPA liquidation, investors are at risk for market loss.

Further, the Court rejected Claimant's argument that adjusting net equity claims for inflation is the fairest method of calculating net equity. To the contrary, an unadjusted distribution of customer property is "not unjust," per the Court's opinion. Citing Circuit precedent, the Court explained that "SIPA was not designed to provide full protection to all victims of a brokerage collapse," and "arguments based solely on the equities are not, standing alone, persuasive." *See SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 983 (2d Cir. 1974). In fact, the Court observed, adjusting Claimants' net equity could actually lead to an unjust result, since each dollar allocated to earlier investors in recognition of inflation reduces the amount of principal recovered by later investors.

Finally, with respect to the one Claimant's request for an interest adjustment to its net equity claim, the Court rejected the Claimant's argument on the same grounds as it rejected Claimants' request for an inflation adjustment.

Conclusion

In rejecting an inflation or interest adjustment to "net equity" claims for customer property under SIPA, the Second Circuit's ruling in *In re Bernard L. Madoff* makes it clear that the law's purpose is to restore investors to their pre-liquidation status, not to protect them from loss. In a SIPA liquidation, investors remain at risk for market loss. For that reason, it is important that investors consult their counsel and financial advisors on how to mitigate any investment-related risks.

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