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The Concept of Net Equity Being Used by the Trustee and SIPC
National Affairs
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I have read the descriptions by Helen Chaitman and Richard Shapiro of their meeting with Thomas McGowan of the SEC, Picard's written statement published in *Dealbook*, and various comments by members of the Google groups about the oral statements by Picard and Harbeck (which I did not hear but which, one gathers, pretty much tracked the written statement in *Dealbook*). Having read these things, permit me to make a few comments.

The Trustee seems to be relying heavily on the 85-year-old decision in *Cunningham v. Brown*. A number of us don't understand this. That decision, in relevant part, held only that, in the circumstances existing there, some payments were unlawful preferences. Why that reasoning supports Picard's definition of net equity escapes us. Beyond that, it is entirely possible, I would think almost a certainty, that the legislative history of SIPA, enacted for specific purposes 46 years *after* the *Cunningham* case, would override any tortuous logic about that case on which Picard may be relying. I myself have not read the legislative history of SIPA, but there are persons who have, and I would bet they have found statements showing that the legislative history is inconsistent with and overrides whatever Picard's and Harbeck's tortuous reading of *Cunningham* may be.

One can also see, quite readily, that the concepts of preferences and net equity are not necessarily related. Net equity is a SIPA concept, preferential payments are a bankruptcy concept. Moreover, even when numbers are brought into the matter, the two concepts can remain unrelated. You can have a *positive* net equity no matter how it is calculated and yet be liable to clawbacks of preferential payments. You can have a *negative* net equity no matter how it is calculated and yet be liable to clawbacks of preferential payments. You can have either a huge positive or a negative net equity no matter how calculated and not have *received* preferential payments, etc. etc.

It thus seems pretty clear that, to the extent Picard and Harbeck are relying on the 85 year old *Cunningham* case, they are to this extent intellectually bereft. It is, moreover, completely illegitimate to distort the concept of net equity for the purpose of increasing potential clawbacks, which is what Picard seems to be doing here, as extensively discussed below.

This is not to say that Picard and Harbeck necessarily are *totally* bereft of prior judicial precedents. My recollection is that, *elsewhere* than in the Second Circuit, *which is governed by New Times* (a case Picard treats as a nonperson, so to speak), there are a few district court cases (in Florida and California if memory serves) which have not awarded phantom profits. But those cases are inapplicable in the Second Circuit, because *New Times* controls there.

To get to the underlying nitty gritty of the matter, it seems that the following must be Picard's and Harbeck's real reasons for defining net equity as they do: (i) Their definition minimizes the extent to which SIPC has to pay money, since it means far fewer people than otherwise will be eligible for a full $500,000 (because, for example, their *November 30th statements* may exceed their "cash out" by a million dollars, while their "*cash in*" may exceed it by only $100,000, thus lowering their SIPC payment from $500,000 to $100,000). And (ii) their definition of net equity enables Picard to claw back more, especially from smaller accounts. A small investor may, for example, have put in $500,000, had a November 30th account showing $1,150,000, and before 2008 have taken out $600,000. (The six month *bankruptcy* preference won't reach the $600,000 because it was taken out before 2008.) Under the legitimate expectations argument, the investor is not subject to clawback because his November 30th statement showed $550,000 more than he took out prior to 2008. ($1,050,000 minus $600,000 equals $550,000.). Under Picard's cash in, cash out theory the investor *is* subject to clawback of $100,000 because he took out $600,000 but put in only $500,000.

It seems obvious that it is illegitimate in the extreme for Picard and Harbeck to use a rigged definition of net equity *in order to lessen the amount people receive from SIPC and to create clawbacks where they otherwise would not exist*. This is obvious as a matter of logic and fairness, and one suspects the legislative history of SIPA shows this as well.

Let me make a final set of points. Having read Picard's statement in *Dealbook,* being familiar with some prior comments he has made, and believing that his legal logic and his reliance on *Cunningham* are at best very weak, it seems to me Picard and Harbeck ultimately will be driven to rely on the following argument in discussions with the SEC and in arguments in court. (The quotes are from Picard's statement in *Dealbook*): The Madoff Ponzi scheme is "the largest and most complex securities fraud in history." It "presents many unique difficulties rarely encountered." It therefore requires a different definition of net equity that will allow Picard to claw back as much as possible in order to assure (his definition of) fairness.

To achieve fairness when calculating net equity, “simple logic suggests that it would not be advantageous to include fictitious profits.” For “all that would be achieved is [to] increase[e] the amount of the claims being divided into the fund ... thereby diminishing the percentage of recovery that all customers would receive.”

Even more importantly in regard to fairness, cash in / cash out should be used in calculating net equity because those “who withdrew more than they put in and withdrew fictitious profits, even unknowingly, actually received someone else’s money.” In this vein “allowing fictitious profits ... will benefit early investors but penalize later ones.” For the claims of the later investors “will largely be for real dollars” but their money “will be used to pay the earlier investors whose claims will largely be based on fictitious profits.”

To put it in brief, especially because *New Times* is against him (as is the legislative history also, I hope), Picard will ultimately be driven to claim that his definition of net equity, and the clawbacks which arise solely because of that definition, are the only fair way to proceed because otherwise some people will receive other people’s money and later investors are at a disadvantage. I also note that, given his views, Picard logically should and may in fact feel compelled to claw back as much as possible from *everyone*, except possibly a few cases where he would be seeking blood from a stone. Otherwise, by his logic, some people will be paid with other people’s money and late investors will be injured, both of which he says are precluded by his version of fairness. Picard’s current, repeated “make nice” comments, even if he really means them (which could be entirely possible, though cynics deny this), could nonetheless prove, because of his own logic, to have been merely a disguise of the ultimate course of action to which his own logic drives him, and, by such disguise, to have been merely a method of lessening the current outpouring of criticism.

Picard’s logic is not wholly unappealing if one considers it solely in the abstract. For in the abstract - and entirely ignoring *New Times*, legitimate expectations, and hopefully legislative history - who would say that a person should be paid with someone else’s money or that latecomers should be unfairly penalized? Yet when one descends from the abstract to the concrete - and even ignoring *New Times,* legitimate expectations and, hopefully, legislative history - the matter of fairness is not so simple as Picard would have it. For example, people and institutions who had scores or even hundreds of millions in Madoff, and who will get scores of millions of dollars worth of tax deductions, probably never took out money from Madoff and *certainly* did not take out more than they put in. They remain eligible for $500,000 in payments under Picard’s net equity formula, with the $500,000 being pocket change to them. But someone who put $500,000 into Madoff and whose November 30th account showed $1.3 million (his entire savings), but who over the years had taken out $750,000 to live and to pay the taxes on Madoff money, will get nothing even though he is in need of the money. Is it fair when the centamillionaire or billionaire gets back $500,000 and is not subject to clawback, but a person who has been wiped out gets nothing and, on top of that, may be subject to clawback?

Nor need the contrast be as stark as this example to raise the question of whether Picard’s *abstract* fairness translates into *concrete* fairness. Even if somebody had as much as two or five or even ten or more million dollars in Madoff, and now has at least enough non Madoff money to live, the contrast between Picard’s abstract version of fairness and a more thorough examination of fairness can be startling when one compares the numbers of such an individual to the numbers for the mega rich.

Nor is it necessarily true that the claims of earlier investors will not involve large amounts of what Picard calls real dollars - money they put in. A host of early investors are making significant claims for real dollars even if part of their claims involves profits shown on their statements.

Moreover, by not including their phantom profits, Picard is in practical effect denying the fruits of their way of (so to speak) "fulfilling opportunity cost" (by investing for a long time in Madoff), whereas he is granting late investors *their* way of "fulfilling opportunity cost" (by investing elsewhere until recently). Why is it fair to grant the late investor the fruits of his opportunity cost strategy while denying it to the earlier investor? (I think this point has been made by a few members of the Google groups.)

There is also another fundamental question regarding Picard's view of fairness. He says net equity must be defined without regard to phantom profits because otherwise the real money of late investors will be used to pay the fictitious profits of earlier ones. But just what does he think happened to the real money invested by the earlier ones? In fact their real money was used to pay the fictitious profits of still earlier ones. Fair and equal treatment would mean recognition that the real money of *all* investors (except those who invested back in the 1960s perhaps) was used to pay fictitious profits of earlier ones, and that if this is true of late investors, it is equally true of prior ones. What Picard and Harbeck are doing by using their cash in-cash out method of calculating net equity is *not* insuring fair treatment to late investors. Rather, they are insuring that late investors get *better* treatment than everyone else because the late investors' money will *not* be used to pay others, whereas everyone else's money *was* used to pay others - others from whom, incidentally, there can be no clawback if they received their money over six years ago. (This was pointed out to me - to give credit where it's due - by Harry Markopolos' attorney.)

And all of this is not even to mention that late investors, unlike earlier ones, are not as likely to have taken out more than they put in, so Picard's cash in-cash out method treats the late investors better than earlier ones on the clawback score as well.

Finally, Picard claims that if phantom profits were to be used when calculating net equity, this would permit Madoff himself to have been the arbiter of what one receives. Well, apart from Madoff's coconspirators, who would get annual returns of 46 and 900 percent, who should get zip from SIPC and who should instead be prosecuted, most people got roughly the same percentage of phantom return each year. Also, if Picard wanted to assign all the innocent people the same percentage of compounded return each year consonant with what most *got* each year (a job that would be child's play with modern computers), no one is going to object very much. But assigning an average return to all each year is far different from screwing everyone by saying that no one gets a nickel of the profits shown on their November 30th statements.

All of this, incidentally, leads back to a point discussed earlier. What are the *real* reasons why Picard and Harbeck are defining net equity as they are. Many think the real reasons are, as discussed earlier, to save SIPC money and to thereby enable it *not* to have to go to Congress for more money and *not* to have to further increase its assessment on the broker dealer community. I would bet that if Picard, Harbeck and their minions are deposed, and if their documents are obtained in discovery - all of which may be entirely possible notwithstanding improper claims of attorney-client and work product privilege that will be raised by persons (e.g., Picard and Harbeck) who were *not acting as lawyers* but as CEOs, Trustees and other officers even though they *happen* to also *be* lawyers - there will be extensive evidence that a desire not to go to Congress and not to levy still higher assessments on broker dealers lies at the root of what Picard and Harbeck are doing. Some who should be in a position to know have told a number of us that SIPC has a corps of "permanent Trustees" so to speak. These persons are often called upon by SIPC to be Trustees and they, as well as the officials of SIPC itself, have, it is said, a very nice life that ranges from economically comfortable to very lucrative. They want nothing to upset the applecart, which could well occur if SIPC has to go to Congress for money or has to further assess the industry.

But a desire to avoid having to go to Congress or the industry for more money, and a desire to continue a nice life, are not good reasons for defining net equity as Picard and Harbeck are doing, or for failing to seek more money from Congress and the industry in order to provide succor to people who have been badly injured and for whom the SIPA was intended to *provide* succor. Still less are these legitimate reasons when they harm innocent people who have already been crushed by the failures of governmental bodies such as the SEC and IRS, or quasi governmental bodies like FINRA.

Gold Medal Awarded to Lawrence Velvel

A new book by essayist Lawrence Velvel, Dean of the Massachusetts School of Law at Andover, has won the 2009 gold medal in the essay/creative category of Independent Publisher, the voice of the independent publishing industry.

The "IPPY" Award was conferred for his non-fiction work *An Enemy of the People: the Unending Battle Against Conventional Wisdom*, published by the law school's Doukathsan Press. The small number of other academic presses to win awards were headed by those of Harvard, Yale, Princeton and Michigan. The "IPPY" award recognizes excellence in independent publishing, and a total of 3,380 books were entered in 85 categories, Independent Publisher said.

Velvel's work contains more than 100 essays that discuss a wide variety of subjects. They include the war in Iraq, the ineptitude of American politics and politicians, America's history of overthrowing foreign governments, Supreme Court nominations, books that impressed him, higher education, medical care, ex presidents' shameful use of their former office to "cash in," the impact on policy of the American South, reactionary decisions by federal judges and, on a lighter note, discussions of University of Michigan football and a comparison of Oscar Robertson and LeBron James.

A previous book of Velvel's essays, *Blogs From the Liberal Standpoint: 2004-2005*, received the bronze medal, in a national competition, from

ForeWord, the magazine for librarians and the book industry. That book was adopted for use in political science classes at Tufts University, Medford, Mass., and the University of California at Berkeley.

Both books of collected essays are taken from Velvel's blog, velvelonnationalaffairs.com, which was listed by *USA Today* in its "The Blogger & Podcaster Guide" of top Internet sites. In addition to his duties at the law school, the prolific Velvel writes, on average, one to two essays a week. His works have been quoted and reprinted widely on internet sites in the U.S. and abroad.

Last year, Doukathsan Press brought out Velvel's unsparing fictionalized memoir, the 818-page quartet "Thine Alabaster Cities Gleam." It chronicles post 1960 cultural declines - a moral meltdown that caused America to go from the world's hope to a country often reviled abroad. Reviewers said the memoir reads like a novel.

Velvel cofounded the Massachusetts School of Law to pry open the doors of the legal profession for minorities, mid-life persons, immigrants and low-income students, who otherwise would generally be excluded from the profession. *The National Jurist* has called him "a modern day crusader" and "one of the most influential people in legal education over the past 15 years." *The National Law Journal* has honored him for his law school's contributions to law school reform.

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BlackCommentator.com *Columnist, Lawrence R. Velvel, JD, is the Dean of Massachusetts School of Law. He is the author of* Blogs From the Liberal Standpoint: 2004-2005 *(Doukathsan Press, 2006). Click here to contact Dean Velvel, or you may, post your comment on his website, VelvelOnNationalAffairs.com.*

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