UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BEACON ASSOCIATES LLC I, BEACON ASSOCIATES LLC II, ANDOVER ASSOCIATES, L.P., ANDOVER ASSOCIATES LLC I, ANDOVER ASSOCIATES (QP) LLC,

Plaintiffs

-vs-

BEACON ASSOCIATES MANAGEMENT CORP., ANDOVER ASSOCIATES MANAGEMENT CORP., INCOME PLUS INVESTMENT FUND, DAVID FASTENBERG, TRUSTEE, LONG ISLAND VITREO-RETINAL CONSULTANTS 401K FBO DAVID FASTENBERG,

Defendants.

Index No. 14-cv-2294

DEFENDANT FASTENBERG'S MEMORANDUM OF LAW IN SUPPORT OF HIS REQUEST FOR A MANDATORY INJUNCTION AND A DECLARATORY JUDGMENT

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BEACON ASSOCIATES LLC I, BEACON ASSOCIATES LLC II, ANDOVER ASSOCIATES, L.P., ANDOVER ASSOCIATES LLC I, ANDOVER ASSOCIATES (QP) LLC, Plaintiffs -vs- BEACON ASSOCIATES MANAGEMENT CORP., ANDOVER ASSOCIATES MANAGEMENT CORP., INCOME PLUS INVESTMENT FUND, DAVID FASTENBERG, TRUSTEE, LONG ISLAND VITREO-RETINAL CONSULTANTS 401K FBO DAVID FASTENBERG, Defendants.	**Index No. 14-cv-2294**

PRELIMINARY STATEMENT

This is not the first time Defendant David Fastenberg[1] ("Fastenberg") has appeared before this Court seeking to compel distribution to investors, including him, of

[1] Defendant David Fastenberg, appears as Trustee of the Long Island Vitreo-Retinal Consultants 401k FBO David Fastenberg. Mr. Fastenberg is counsel also represents approximately 170 other investors in the Plaintiff Beacon Funds.

funds currently held by the Plaintiff Beacon Funds[2]. As the Court is well aware, all of the Beacon Funds invested the large majority of their assets with Bernard L. Madoff Investment Securities LLC ("BLMIS"). [3] The BLMIS investments were written down to zero upon the discovery of the Ponzi scheme crimes of Bernard L. Madoff ("Madoff") in December of 2008, and shortly thereafter the determination was madeto liquidate the funds.

In the last action, *Beacon Associates Management Corp. v. Beacon Associates LLC I*, No. 09 Civ. 6910, Fastenberg argued that the assets then remaining in the Beacon Funds, comprised exclusively of Non-Madoff assets, should be distributed on the basis of the December 2008 Net Asset Value maintained for each investor on the books of the Beacon Funds (the Valuation Method). The Court adopted his arguments and granted the requested mandatory injunction. *Beacon Assocs. Mgmt. Corp. v. Beacon Assocs. LLC I*, 725 F. Supp. 2d 451 (S.D.N.Y. 2010). (hereinafter "*Beacon I*") In that proceeding, there were counter-veiling equities because the parties were determining how to calculate and distribute Non-Madoff profits, *real* profits, and not the fictitious profits at issue here. As this Court held, "while application of the Valuation Method allows Madoff-related "fictitious profits" to inflate member interests, application of the Net Investment Method would strip investors of legitimate gains from Beacon's significant non-Madoff investments." *Id.* at 464. Most importantly, any attempt to disentangle the effect of the Madoff fictitious profits would also result in inequitable effects. As the Court stated:

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[2] The Plaintiffs, Beacon Associates LLC I, Beacon Associates LLC II, Andover Associates L.P., Andover Associates LLC I, and Andover Associates LLC (QP) are hereinafter referred to collectively as "Beacon Funds" or "Funds".

[3] The Beacon Funds invested approximately 75% of their assets in Madoff investments and 25% in legitimate non-Madoff investments. For the Andover Funds, the percentages were reversed.

> Even if Beacon's accountants were capable of netting out each members BLMIS investments while properly allocating the legitimate profits gained from other investment managers (which the Court has no way of knowing), attempting to do so would be very "time-consuming" and "expensive." (H. 76-77.) ... Because Beacon has a finite amount of resources and its members have waited close to two years to receive their money, spending more investor money while tying up the funds for an indefinite period would be counterproductive.

Id. at n.22.

In this proceeding, however, Fastenberg urges the Court to take the opposite approach and to ignore the Net Asset Value, a number arrived at using Madoff's arbitrary calculations of purely fictitious profits, and instead use the Net Investment Method, sometimes called the Net Equity or cash-in/cash-out method, for determining each investor's distribution. This *is not a change* of Fastenberg's view as to what should have happened in the last proceeding, which we continue to believe was correctly decided. Instead, it is the facts which have changed: in the last proceeding, the money being distributed was, exclusively, Non-Madoff assets; now, the money being distributed is exclusively money which has been received or will in the future be received by the Beacon Funds from BLMIS.

To put it differently, in this proceeding the Court is determining how to distribute to investors the return of their money invested in BLMIS through the "conduit" of the Beacon Funds. The Trustee is simply returning to the Beacon Funds the cash that the Funds invested in BLMIS. The Trustee computes the money to be returned to the Beacon Funds using the Net Investment or cash-in/cash-out method. We urge the Court to adopt that same method for distributing the money to the Beacon Funds' investors that was used in computing the money distributed by the Trustee to the Beacon Funds.

Indeed, to do as urged by the Income Plus Investment Fund, and to use the Net Asset Values derived from the fictitious Madoff Statements, would be to turn the Beacon Funds into a Ponzi scheme, where the fictitious profits of the "earlier investors are paid from the investments of more recent investors." *See, In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 232 (2d Cir. 2011) (describing typical Ponzi scheme), *quoting, Eberhard v. Marcu*, 530 F.3d 122, 132 n.7 (2d Cir. 2008). As with the typical Ponzi scheme, the Income Plus Investment Fund, a long time Beacon Fund investor, seeks to obtain for itself the benefit of fictitious profits, at the expense of the newer investors who have not even gotten back a return of their original investment. See, Folkenflik Dec.¶ 4.

The Courts which have addressed similar issues in Madoff-related proceedings have emphatically rejected that approach on public policy as well as statutory construction grounds. *See*, *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 238 (2d Cir. 2011)(describing the "The inequitable consequence of [relying on the Madoff Statements] would be that those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed."); *Sec. Investor Prot. Corp.* v. *Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010) ("Any dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested. If the Last Statement Method were adopted, Net Winners would receive more favorable treatment by profiting from the principal investments of Net Losers, yielding an inequitable result."); *See also*, *CFTC v. Walsh*, 712 F.3d 735, 754 (2d Cir. 2013)(" It was well within the district court's discretion to conclude that, as a

matter of equity, some of the similarly situated victims should not profit at the expense of the other victims."); *Stafford v. Giddens* (*In re New Times Sec. Servs.*), 463 F.3d 125, 130 (2d Cir. 2006) (treating the fictitious paper profits as within the ambit of the customers' 'legitimate expectations' would lead to the absurdity of 'duped' investors reaping windfalls as a result of fraudulent promises made on fake securities.").

Similarly, in negotiating the settlement of actions brought by Beacon Fund Investors the Department of Labor and the New York State Attorney General against various defendants for fraud related to the Beacon Funds' investments in BLMIS, the Department of Labor and the New York State Attorney General insisted on using the Net Investment/cash-in/cash-out method of computing the losses of the Beacon Funds investors. See, Folkenflik Dec.¶ ¶ 23-24.

Because the money to be distributed is all Madoff money, returned to Beacon by the Trustee on the basis of the Net Investment by the Beacon Funds, Defendant Fastenberg believes that distribution by the Beacon Funds using the Net Investment Method is required. To use the Valuation method would be to *convert the Beacon Funds into a Ponzi scheme* where earlier investors receive fictitious profits from the investment made by later investors, and later investors do not even get their investment back.

However, the distribution of non-Madoff assets should follow the 2010 Order of this Court, and be made on the Valuation Method. As everyone recognizes, there is no "perfect" solution under the tragic circumstances of this case, but the use of the two methods, Valuation for the Non-Madoff assets and Net Investment for the Madoff assets, both gives the earlier investors "legitimate gains from Beacon's significant

non-Madoff investments," *Beacon I* at 464, while properly returning money stolen by Madoff to the investors from whom it was stolen.

Nothing in the law requires that the Court ignore equity and reality in favor of the "absurd result" which would occur if the Valuation Method were applied to determine the method of distribution. Traditional equitable principles and public policy all require the sensible result of determining distribution using the Net Investment Method.

I. FACTS

Beacon I is a limited liability corporation formed in 1995 for the purpose of investing the funds of its members in other investment funds chosen by Beacon I in its discretion. The other Beacon Funds are also limited liability corporations with the same investment purposes.

Since the inception of Beacon I through December 2008, the Beacon Funds invested a substantial portion of its assets under management with BLMIS, 70% to 75% for the Beacon funds, and the reverse, 25% to 30% for the Andover Funds. Beacon's Operating Agreement provided that Management should calculate what it referred to as the "Sharing Ratios," that is, the proportionate share of the Beacon Funds' net asset value ("NAV") attributable to each member, by starting with the investor's initial capital contribution, then adding any profits earned and subtracting any losses incurred from Beacon's investment activities, and adding any new contributions made by that investor, and subtracting any withdrawals. Folkenflik Dec.¶ ¶ 5-6. Throughout that period, BLMIS reported fictitious "profits" in each and every year, which were credited to the net asset value of the Beacon Funds. Since the inception of the Beacon Funds through December 2008, therefore, member's capital

accounts, their individual NAV, included fictitious "profits" reported to be earned by BLMIS.

On December 11, 2008, Madoff was arrested and confessed to running the largest Ponzi scheme in history. An action was commenced in the United States District Court for the Southern District of New York to appoint a trustee to supervise the collection and liquidation of assets of BLMIS. Thereafter, on December 15, 2008, an application for a protective decree pursuant to 15 U.S.C. § 78EEE(a)(3) of the Securities Investor Protection Act ("SIPA") was filed in the United States Bankruptcy Court for the Southern District of New York (the "SIPC Bankruptcy") seeking liquidation of BLMIS. Irving H. Picard was appointed as Trustee in the SIPC Bankruptcy.

The revelation of the Madoff thefts had a significant impact on Beacon I. First, the Beacon Funds determined to write down to zero the full extent of its then-existing investments in BLMIS. The effect of that write-down was to reduce the capital accounts of the Beacon Funds, and correspondingly the capital accounts of each of the members of the Beacon Funds by approximately 75%. Notably, this "write-down" did not involve any adjustment of individual NAV to correct the distortions resulting from the impact of Madoff fictitious profits. An investor with a 1% "sharing ratio" in the Beacon Funds before the write-down, continued to have a 1% interest in the Beacon Funds after the write-downs. The share of the pie was the same, but the pie had become (or actually had been recognized as being) much smaller than before. Folkenflik Dec.¶ 9.

On December 18, 2008, Beacon Management determined to liquidate the Beacon Funds. Because approximately 25% of the balance of assets remaining in Beacon I were invested with other managers, some of whom had restrictions on the timing of withdrawals of funds from their control, the liquidation was expected to take a number of months. the Beacon Funds informed their members that it would distribute funds remaining in the Beacon Funds to all investors on or about July 15, 2009.

Initially, the Beacon Funds made computations of the remaining assets in the Fund, and the amount that members could expect in liquidation. Those computations were done consistently with the historical practice of Beacon I in computing the NAV of the Fund and the capital account of each member. The write-down for the BLMIS losses was made as of the date that those thefts were discovered.

Sometime prior to the end of May 2009, Beacon Management sought an opinion from Roberts & Holland concerning the proper method of computing the distribution of Beacon I's then remaining assets among its members. By letter dated May 27, 2009, Roberts & Holland issued its opinion. Roberts & Holland did a detailed analysis of Beacon's Amended and Restated Operating Agreement dated as of April 1, 2004, which contains the usual method to be followed for the computation of investor capital accounts and each investor's share of Beacon I's profits and losses (the "Beacon I Operating Agreement"). (A copy of the Beacon I Operating Agreement is annexed to the Folkenflik Declaration as Exhibit B.) The other Beacon Funds contain parallel provisions.

Thereafter, Beacon I issued its 2008 financial statements. Beacon's accounts, Citrin Cooperman & Company LLP ("Citrin Cooperman") issued an unqualified opinion on those financial statements. Note 5 to the 2008 financial statements states that the losses on assets held with BLMIS were recorded effective as of December 2008. The note states that "as the company is unable to determine when the loss actually was incurred, the amount of the loss attributable to previous reporting periods cannot be quantified." The other Beacon Funds produced similar financial statements which were opined on in substantially identical accountants'opinions.

In each of the years prior to 2008, from the inception of the Beacon Funds in 1995, members of the Beacon Funds received forms K-1, which included fictional investment income reported by BLMIS as part of its Ponzi scheme. As a result, each member's Net Asset Values were inflated by the fictitious "profits" reported on the Beacon Funds' BLMIS investments.

The Roberts & Holland Opinion had noted that Roberts & Holland had been informed by Citrin Cooperman that there was a possibility that other accountants might conclude that the Beacon Funds' financial statements for prior years should be restated to eliminate BLMIS income and to report BLMIS losses *when they occurred*, rather than *when they were discovered*. As a result, Beacon Management declined to distribute the assets of the Beacon Funds on that basis of accounting to its member until it received a ruling from a court declaring that the Valuation Method was the proper method to be used.

II. THE *BEACON ASSOCIATES MANAGEMENT CORP. V. BEACON ASSOCIATES LLC I DECISION*

As a result of the dispute that arose over the proper methodology to follow in valuing the capital balances attributable to individual Fund investors for purposes of distribution of the non-Madoff invested funds, the Fastenberg Intervenors filed a motion in the United States District Court for the Southern District of New York seeking a mandatory injunction compelling Management to distribute the Beacon Funds' remaining assets "proportionately in accordance with the capital accounts of the investors less a write-down for the Madoff theft losses on the date of the discovery of those losses." *Beacon I.* While recognizing that none of the alternatives proposed by management was perfect, but speed and pragmatism strongly favored using the Valuation method.

The Fastenberg Intervenors argued that any of the other proposed restatement alternatives were deeply flawed, perhaps ultimately unprovable, and invited years of contention and delay. The Fastenberg Intervenors argued that these investors, who had undeniably earned a share of the Non-Madoff funds, were entitled to get whatever money back they could, as quickly as possible. As we said in our Memorandum of Law in Support of the Fastenberg Interveners Motion for Judgment:

> Finally, and perhaps most importantly, for the reasons pointed out above, even if restatement of the investor capital accounts is allowed by the Beacon I Operating Agreement and governing accounting standards, it will take years before the necessary facts are developed and years of costly litigation paid for by investors out of Beacon I's assets, to determine which restatement method is the proper one and that it has been properly applied. In the meantime, the investors will have lost the use of their funds, which are sitting in Treasury instruments, earning essentially nothing. Nothing in the Beacon I Operating Agreement, the law, or accounting standards, compels the Court to require such an iniquitous result. Not only the applicable contract and the law, but simple justice, requires the distribution of the assets of Beacon I be made

> promptly so that these investors who have lost so much can recover what little is available to them and start to put their lives back in order.

Id. at 17-18, *Beacon Associates Management Corp. v. Beacon Associates LLC I*, No. 09 Civ. 6910, Docket No. 25.

After the initial papers were filed by the parties to the action, the Court provided an opportunity for all Beacon Fund investors to file papers in connection with the motion. The Fastenberg Intervenors' motion was opposed by a Beacon member, who wished the distribution to occur not on the basis of the Valuation Method, which "recognizes fictitious gains," but the Net Investment Method, which would not result in giving "credence" to fictional profits. *Beacon I*, 725 F. Supp.2d at 459.

The Court concluded, for several reasons, that with respect to the assets then remaining in the Beacon Funds, which were comprised exclusively of Non-Madoff profits and return of Non-Madoff capital, the Valuation Method should be used. *Id.* at 460. The Court noted that the Operating Agreement called for application of the Valuation method, but that fact was not determinative in reaching the Court's conclusion. The Court found it very significant that Beacon's counsel surveyed all of Beacon's members and, overwhelmingly, the Valuation Method was the method the majority of members wished to see used in making the distributions. *Beacon I*, 725 F.Supp.2d 451, 463. Many of those supporting use of the Valuation method did so on pragmatic grounds.

The Court recognized the long line of authority which applied the Net Investment Method, rather than relying on the values reflected in monthly account statements in cases involving Ponzi schemes, but the Court reasoned that the cases

employing the Net Investment Method of distribution simply did not apply to the case because Beacon was not a Ponzi scheme. Furthermore, the court reasoned that application of the "Net Investment Method would strip investors of legitimate gains from Beacon's significant non-Madoff investments." *Id.* at 464. Accordingly, the Court granted the Fastenberg Intervenors' motion to distribute Beacon's non-Madoff invested funds in accordance with the Valuation Method.

III. THE CURRENT DISPUTE

Following the decision and order in *Beacon I*, approximately $133 million was distributed to Beacon Fund investors using the Valuation method. As a result, those long term investors who had their NAV artificially inflated by fictitious Madoff profits, shared in that distribution as if those fictitious profits had been real.

The SIPC Trustee asserted a claim against the Beacon Funds for all withdrawals they had made from BLMIS from inception, in an amount exceeding $28 million, without regard for the fact that additional investments almost equaled the amount of withdrawals, or the fact that the Beacon Funds' aggregate investments substantially exceeded the amount withdrawn. (the "*Trustee's Claw-Back Action*"). As the Court is undoubtedly aware, the Trustee has been very successful in collecting assets for the BLMIS Estate, and significant distributions have been made to BLMIS investors. However, during the pendency of the Trustee's Claw-Back Action, the Trustee refused to make any distributions to the Beacon Funds.

Numerous class actions, individual actions and suits by the Department of Labor (the "DOL") and a suit under the Martin Act by the New York State Attorney General (the "AG") has been filed against the Beacon Funds or against its managers

and others, including in particular Ivy Asset Management Inc., which had been purchased by the Bank of New York (collectively the "*Beacon Actions*").

The *Beacon Actions* and the *Trustee's Claw-Back Action* were submitted to mediation before David Gerronemous, Esq. of JAMS in several sessions during the starting in November 2012, and all of those actions were settled. Notably, none of the money recovered in the settlement of the Beacon Actions was paid to the Beacon Funds. At the insistence of the DOL and the New York State Attorney General, those recovered funds were paid directly to the Beacon Funds investors. Also notably, the DOL and the New York State Attorney General insisted that the distribution amounts be calculated using the Net Investment Method, and not the Valuation Method. The distributions took into account all amounts paid out from the Beacon Funds, including in particular the amounts distributed pursuant to this Court's order in 2010.

Because the settlements included settlement of class actions pursuant to Rule 23, the settlement and plan of distribution required court approval. By order dated May 9, 2013, Judge Colleen McMahon of the United State District Court for the Southern District of New York approved the settlement and plan of distribution.

As a result of the settlement of the Claw-Back Action, the Trustee Allowed a claim by the Beacon Funds of in excess of $159,867,924.62 for the Beacon Funds and $5,032,817.38 for the Andover Funds, and released and distributed to the Beacon Funds its pro rata share of portions of the amounts recovered by the Trustee for the BLMIS Estate. The Trustee is computing the pro rata share of each investor's recovery, including the recovery by the Beacon Funds, using the Net Investment Method. Currently, the Beacon Funds have received tens of millions of dollars from

the Trustee, but there is no agreement on how the distribution of those amounts by the Beacon Funds will be calculated for individual investors.

On April 2, 2014, counsel for the Beacon Funds commenced an action in the United States District Court for the Southern District of New York, *Beacon Associates LLC I v. Beacon Associates Management Corp.*, No. 14 Civ. 2294, by filing a Complaint for Declaratory Judgment (the "Complaint"). In their complaint, counsel for Beacon I explains the two available methods of distribution – Net Equity and Valuation. (*See* Folkenflik Dec. Exhibit A, Complaint ¶¶ 40, 41.)

Now before the court is another motion by the Fastenberg compelling distribution of funds. This time, Fastenberg seeks distribution pursuant to the Net Investment Method, the same method that has been used by the Trustee, the same method that was insisted upon by the DOL and the New York State Attorney General, the same method that has been used in every Madoff case dealing with distribution of BLMIS Estate assets to date.

ARGUMENT

POINT I
EQUITY DEMANDS THAT THE NET INVESTMENT METHOD BE APPLIED TO DISTRIBUTE THE MADOFF FUNDS TO BEACON FUNDS' INVESTORS

The relief being sought from this Court is all equitable in nature. *See, DiTolla v. Doral Dental IPA of New York*, 469 F.3d 271,276 (2d Cir. 2006)(injunctive and declaratory relief are equitable in nature). In cases brought seeking equitable relief, as Judge Cardozo noted nearly a century ago in *Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 389 (1919), "[t]he equity of the transaction must shape the measure of relief." "Under common law principles it is well established that equitable discretion may

sometimes be exercised to avoid harm to the public interest or unconscionability to a party that would be the consequence of the unflinching application of legal principles." *Fin. One Pub. Co. v. Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 344 (2d Cir. 2005) (footnote omitted), *citing*, *Kaminsky v. Kahn*, 23 A.D.2d 231, 259 N.Y.S.2d 716, 723 (App. Div. 1st Dep't 1965) (noting that court has equitable power to adapt relief to "exigencies of the case").

"The power of equity is as broad as equity and justice require . . . ." *London v. Joslovitz*, 279 A.D. 280, 110 N.Y.S.2d 58, 59-60 (App. Div. 3d Dep't 1952) (per curiam). A Court sitting in equity has equitable power "to devise whatever remedy it believes in its discretion is necessary *to make injured parties whole*." *Grand Union Co. v. Cord Meyer Dev. Co.*, 761 F.2d 141, 147 (2d Cir. 1985) (applying New York law) (internal quotations marks and ellipsis omitted) (emphasis supplied).

In deciding between application of the Net Investment method of distribution and the Valuation method of distribution for Madoff recoveries from the SIPC Trustee, there is little question as to what equity requires. The Net Investment Method is designed "to make injured parties whole" by returning to investors what they have lost. It mirrors precisely what the SIPC Trustee has done in computing the amounts payable to the Beacon Funds based on the Beacon Funds' net investments in BLMIS.

The Valuation method, by contrast, is designed to treat the Madoff fictitious profits as real, and to pay out those fictitious profits *using the money invested by later investors*, even while those later investors continue to suffer losses. Paying early investors fictitious profits with the money invested by later investors is the defining feature of a Ponzi scheme. *See In re Bernard L. Madoff Investment Securities, LLC*, 654

F.3d 229, 232 (2d Cir. 2011) ("*Madoff II*"). For the Court to order distribution of the money received from the Madoff Trustee by the Valuation Method would result in transforming the Beacon Funds themselves into a Court-ordered Ponzi scheme. Surely equity would not tolerate, let alone require, such a result.

The fact that equity requires use of the Net Investment Method for distribution of Madoff funds is confirmed by the decisions in the Madoff SIPC proceedings themselves. Concededly, those cases arose in other contexts, but the equities they recognize are directly applicable to the matter before this Court. In *In re Bernard L. Madoff Investment Securities LLC*, 424 B.R. 122 (2010) ("*Madoff I*"), Bankruptcy Judge Lifland upheld the Trustee's determination to apply the Net Investment Method to the distribution of funds recovered by the BLMIS Estate.

As Judge Lifland explained: "A fund of 'customer property' consists of assets garnered by the SIPA [Securities Investor Protection Act] trustee on account of customers. These assets are not ascribable to individual customers, but rather are distributed pro rata to the extent of a customer's Net Equity. See SIPA § 78lll(4) (defining "customer property"). *Madoff I* at 125. "Net Equity" is a term used in the SIPA statute, and the dispute in that case was over how to determine what the "net equity" was. As Judge Lifland explained: "The Trustee defines Net Equity as the amount of cash deposited by the customer into his BLMIS customer account less any amounts already withdrawn by him (the 'Net Investment Method'). In contrast, the Objecting Claimants define Net Equity as the amounts reflected on customers' November 30th [2008] Statements (the 'Last Statement Method')." *Id.*

The Objecting Claimants were chiefly the so-called "net winners" who had already recovered more than the amounts they had invested with Madoff. Like Defendant Income Plus, here, they sought to receive distributions based on "fictitious profits" even though were they to do so, other investors likely would receive less than the amount they had lost.

After an extensive review of applicable provisions of SIPA and the Bankruptcy Code, as well as the IRS rulings on deductibility of Madoff losses and Second Circuit precedents of *New Times Sec. Servs.*, 371 F.3d 68, 87-88 (2d Cir. 2004) ("*New Times I*") (which Judge Lifland summarized as "rejecting the District Court's Net Equity calculation, which was based on customers' 'legitimate expectations'") and *New Times Secs. Servs.*, 463 F.3d 125, 130 (2d Cir. 2006) ("*New Times II*") (which held that "treating the fictitious paper profits as within the ambit of the customers' 'legitimate expectations' would lead to [] absurdity . . . ."), the bankruptcy court agreed with the Trustee and held that the claimants' Net Equity in the BLMIS Estate could only be determined by the Net Investment Method.

While *Madoff I* turned on an issue of statutory interpretation not at issue here, the bankruptcy court's emphatic rejection of the Valuation method for determining the proper distribution of funds recovered by the Trustee is a guide to the proper application of equitable principles in this case. Judge Lifland held that "[t]he Net Investment Method is appropriate because it relies solely on unmanipulated withdrawals and deposits and refuses to permit Madoff to arbitrarily decide who wins and who loses." *Id.* at 140. He also held that the "account statements [were] entirely fictitious, d[id] not reflect actual

securities positions that could be liquidated, and therefore [could not] be relied upon to determine Net Equity." *Id.* at 135. The bankruptcy court continued:

> The BLMIS books and records expose a Ponzi scheme where no securities were ever ordered, paid for or acquired. Because 'securities positions' are in fact nonexistent, the Trustee cannot discharge claims upon the false premise that customers' securities positions are what the account statements purport them to be. Rather, the only verifiable amounts that are manifest from the books and records are the cash deposits and withdrawals.

Id.

In affirming the bankruptcy court's approval of the Net Investment Method, and rejection of the Valuation Method, then Second Circuit Chief Judge Jacobs cited the "powerful reasons for the Trustee's rejection of the Last Statement Method for calculating 'net equity'" The Second Circuit held:

> Here, the profits recorded over time on the customer statements were after-the-fact constructs that were based on stock movements that had already taken place, were rigged to reflect a steady and upward trajectory in good times and bad, and were arbitrarily and unequally distributed among customers. These facts provide powerful reasons for the Trustee's rejection of the Last Statement Method for calculating "net equity." In addition, if the Trustee had permitted the objecting claimants to recover based on their final account statements, this would have "affect[ed] the limited amount available for distribution from the customer property fund." *In re Bernard L. Madoff*, 424 B.R. at 133. The inequitable consequence of such a scheme would be that those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed.

Madoff II, 654 F.3d 229, 238

The same "powerful reasons" exist here for rejecting the Valuation Method. The same "inequitable consequences" would occur if this Court ordered that the Valuation Method should be applied to the distributions from the Beacon Funds.

In a recent decision involving further fallout from the Madoff fraud, *Hecht v. Andover Associates Management Corp.*, 979 N.Y.S.2d 650, 653 (2d Dep't 2014), the Appellate Division New York Supreme Court reached a similar result, based on a similar analysis. That case involved losses sustained by one of the Beacon Funds from its investments in BLMIS. One of the fund's members brought suit derivatively on behalf of the fund against the fund's managing member and its independent auditor. *Id.*

The auditor moved to dismiss the professional negligence claim against it, which the New York Supreme Court denied, but in so doing, the lower court also denied the plaintiff's request to recover the profits that Madoff fraudulently claimed the fund had earned. *Id.* at 652. The auditor appealed, and the plaintiff cross-appealed the denial as to damages. The Appellate Division affirmed the lower court's denial of damages for losses based on the Madoff statement valuations holding that, "[w]hen a party seeks damages for lost profits, the profits may not be imaginary." *Hecht*, 979 N.Y.S.2d at 653. The court continued: "It is undisputed that the profits reported by Madoff were completely imaginary. The fictitious profits never existed and, thus, Andover did not suffer any loss with respect to the fictitious sum." *Id.*

Other cases outside of Madoff-related proceedings have reached the same result. In *In re Pearlman*, the debtors bilked their investors out of hundreds of millions of dollars through multiple Ponzi schemes. 484 B.R. 241 (Bankr. M.D. Fl. 2012). The Chapter 11 Trustee, tasked with distributing funds to general unsecured creditors, had received over 2,500 investor claims totaling more than $1 billion from investors in the debtors' Ponzi schemes. *Id.* at 242. The investors, in making their claims, attached their last account statements, which reflected interest and dividends. *Id.* The Trustee, however, to ensure

fairness, wanted to distribute funds using the Net Investment Method, and asked the court for an order decreeing so. *Id.*

The court, in its analysis, turned almost immediately to the *Madoff I* for guidance, and quickly announced its agreement "with the rationales for accepting a net investment methodology instead of an account statement methodology." *Pearlman*, 484 B.R. at 244. Not lost on the court was both the bankruptcy court and the Second Circuit's intense focus on the absolute unreliability of the account statements that the investors wanted the Trustee to use to establish their net equity. The *Pearlman* court described the New York bankruptcy court's view of those financial positions as "only as good as the paper they were written on because, in actuality, they were a fictitious perpetration of Madoff's Ponzi scheme and 'did not reflect actual securities positions that could be liquidated.'" *Id.* at 243-44 (quoting *In re Bernard L. Madoff Investment Securities, LLC*, 424 B.R. 122, 134 (Bankr. S.D.N.Y. 2010). In referencing the Second Circuit's affirmance, the *Pearlman* court quoted directly from the Second Circuit's opinion – that the "Ponzi scheme's account statements 'reflected amounts that necessarily had no relation to reality.'"

Equity does not enforce fiction over reality, nor does it allow some investors to profit from fraud at the expense of other investors. What equity demands in this case, as every court and every regulator who has reviewed the equities in this case has held, that the recoveries from Madoff assets and on account of Madoff loses must be distributed by the Net Investment Method.

POINT II
THE OPERATING AGREEMENT SHOULD NOT BE ENFORCED BECAUSE IT WOULD VIOLATE PUBLIC POLICY

A separate and independently sufficient ground to deny an order compelling the Beacon Funds to apply the Valuation Method is that to do so would violate public policy. "It is well settled that a court will not enforce a contract that violates public policy" *New York State Correctional Officers & Police Benevolent Ass'n v. State*, 94 N.Y.2d 321, 327 (1999), *Oubre v. Entergy Operations*, 522 U.S. 422, 431 (1998) (a contract which violates the law or public policy is void).

Furthermore, application, in the instant case, of the Net Investment Method is obligatory if the court wishes to put an end to and not perpetuate the pervasive fraud that Madoff successfully carried on for years. Recognizing as authentic the profits reflected on the statements, profits that were wholly false, breathes life into Madoff's fiction, converting it from make believe to truth. This, courts have declared, is the very justification for application of the Net Investment Method when dealing with consequences stemming from financial fraud such as Ponzi schemes, for "recognizing claims to profits from an illegal financial scheme is contrary to public policy because it serves to legitimate the scheme." *SEC v. Credit Bancorp, Ltd.*, No. 99 Civ. 11395 RWS, 2000 WL 1752979, at *40 (S.D.N.Y. Nov. 29, 2000).

This policy concern was pervasive in the *Pearlman* decision as well. *In re Pearlman*, 484 B.R. 241. In that case, the court stressed that "allowing some investors to stand behind the Ponzi scheme fiction would condone it, to the detriment of other defrauded investors, and to carry it to a 'fantastic conclusion.'" *Id.* at 244. In approving the Net Investment Method, the court stressed that "recognizing returns from an illegal

financial scheme is contrary to public policy inasmuch as it legitimizes the proscribed investment scheme." *Id.* For this reason alone, even though the Operating Agreement may require application of the Valuation Method to distribution of Non-Madoff assets, to apply that method to the distribution of Madoff fictitious profits would perpetuate the fraud and violate public policy.

In enforcing the Valuation Method in the Operating Agreement last time, the Court relied upon *Lanier v. Bowdoin*, 282 N.Y. 32, 38 (1938). *Madoff I* 725 F. Supp. 2d at 464. Yet as *Lanier* itself recognized, the terms of a partnership agreement must yield where that agreement runs afoul of "considerations of public policy." The public policy in this case against enforcing an Operating Agreement which would perpetuate Madoff's fraud, requires that the Operating Agreement yield, and that the Net Investment Method be used to compute the distribution of Madoff assets from the Beacon Funds.

CONCLUSION

On the last motions relating to the distribution of Non-Madoff assets, this Court noted the counterveiling equities presented there, including the fact that applying the Net Investment Method in that case would "strip investors of legitimate gains from Beacon's significant non-Madoff investments," *Madoff I* 725 F. Supp. 2d at 464, and the potential for expense, litigation and delay if the Net Investment Method was adopted. *Id.* n.22. As a result the Court was was "unpersuaded that equity demand[ed]" that the Valuation Method set forth in the Operating Agreement should not be followed. *Id.* at 464. Here, the previously identified counter veiling equities do not exist, and the simple question is whether equity allows this Court to order that early investor fictitious profits should be

paid from funds invested by later investors, thereby causing the exact type of inequity on which every Ponzi scheme depends. Such a result is not merely inequitous, but also it is against public policy.

For all of the above reasons, the Defendant Fastenberg respectfully request that the motion be granted in all respects, and that a mandatory injunction be issued requiring distribution of the Madoff recoveries from the Trustee based on the Net Investment Method.

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Respectfully submitted,

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