TAX ANALYSIS OF MADOFF THEFT

Jaime Cuevas Dermody 25 January 2009 page 1 of 5

561 278-4100 jaime@fe.net

(0.) INTRODUCTION

We analyze here the US-tax implications for an interesting 2008 theft loss. The loss is from an individual's brokerage account (in a US taxpayer's name) managed by Bernard L. Madoff Investment Securities LLC. To simplify our analysis, we make two assumptions. First, assume that there were no profits or losses in any managed account from trading. Second, assume that all losses occurred when funds were transferred from one account to another, in order to fund the part of redemptions that were phantom profit, without knowledge or approval of any client. If significant trading profits or losses did occur, then the conclusions will be far more complex. Further assume that the victim's taxes were timely filed for all previous years. We will refer to such victim as "Taxpayer".

In (1.), we consider the loss discovered in Taxpayer's account on 11 December 2008. It is an IRS Code Section 165 ordinary loss, which reduces Taxpayer's 2008 ordinary income. It will be the amount stolen from the account, minus any recovered assets and SIPC[1] payment. If this results in a net operating loss for 2008, then Taxpayer may carry back the net loss against taxes paid in 2005, 2006 and 2007, and forward until 2028.

In (2.), Taxpayer can file amended 2005, 2006, and 2007 tax returns, on Form 1040X, to reflect the real absence of any income reported from that brokerage account. In (3.), Taxpayer may file, under Section 6511, for a refund from the taxes paid in 2006, 2007, and 2008, based on those carryback losses on Form 1045.

In (4.) we treat the obscure IRS Code Section 1341. Taxpayer can further reduce their 2008 tax payment by an amount, associated with a previous tax payment, if three criteria of Section 1341 (a) are met. There is no limit on how many years ago this previous tax payment occurred. In the 2nd, 3rd, 4th, 5th, and 8th Appeals-Court Circuits, the current interpretation of the second of those criteria requires Taxpayer to have "restored" an "item included in gross income", e.g., to return an asset. This severely reduces the set of Taxpayers that can benefit form Section 1341. Taxpayers in other circuits are free to take the position that this is not the law. Under those criteria, taxpayers can reduce their current-year tax payment by the greater of the reduction in tax paid: from such item being removed from that previous tax year, or from that item being subtracted from the current tax year. This current interpretation leads to nonsensical disparities, and we suggest a simple legislative fix. In (5.) we discuss two different paradigms, which can be used by the bankruptcy court to resolve the Madoff theft. They lead to very different before and after-tax before and after-tax results for Taxpayers in various circumstances.

(1.) THEFT LOSS IN 2008

The loss from theft of an asset (brokerage account assets), purchased in any transaction entered into for profit (as was the case for our Taxpayer) is governed by Section 165, given below. Theft loss occurs for tax purposes in the tax year it is discovered, and the Madoff theft was discovered on 11 December 2008. In general, the federal courts respect state law for determining if a theft has occurred. A theft clearly did occur under New York law, where Madoff operated.

---

[1] Securities Investment Protection Corporation is a nonprofit membership organization established by the Securities Investor Protection Act of 1970. Almost all brokers and dealers registered under Section 15(b) of the Securities and Exchange Act of 1933 are members. It insures $500,000 of securities in the investor accounts at member brokers, against the inability of the broker to deliver customer assets. There is a $100,000 limit on such insurance for investor cash.

See the Appendix for the statutory definition of larceny in New York State. However, the uncertainty over how much, if any, of the assets in the managed accounts will be salvaged and paid out to Taxpayers, raises the possibility that the IRS will take the position, that taxpayers can not recognize the loss until they have certainty of the net-loss amount. It is likely that the IRS will publish guidance in the first quarter on 2009 on the timing and amount of this loss, in order to avoid a wide variety of filing position by taxpayers.

"Sec. 165 Losses

(a) General rule
There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction
For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals
In the case of an individual, the deduction under subsection (a) shall be limited to--
(1) losses incurred in a trade or business;
(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

(d) Wagering losses
Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) Theft losses
For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss."

Since the losses in question do not meet the criteria of Section 165 (c) (3), they are not "personal casualty losses" as defined in Section 165 (h) (4) (B). Despite media reports that the IRS may contest that a theft occurred, the Justice Department arresting Mr. Madoff for theft makes that the Government's position. The facts and politics of the situation make it unlikely that a Taxpayer will have a contest on theft. Thus, the losses are not limited to the excess over $100 and to the excess over 10% of the taxpayer's AGI, as specified in Section 165 (h) (4) (B). Similarly, the loss at hand does not meet the criteria of paragraphs: (d) Wagering losses, (f) Capital losses, (g) Worthless securities, or other paragraphs that would further limit the deduction, e.g., paragraph (f) limits losses to capital gains on the sale or exchange of assets via Section 1211. In Section 165 (b), loss is valued at its cost basis under Section 1011.

(2.) CARRYBACK & CARRY FORWARD 2008 NET-OPERATING LOSS

SECTION 172 (a) and (b) governs the maximum length of time a taxpayer is allowed between:
- filing a tax return in a given prior year, to the
- filing of a request for a refund of taxes that were paid for that given prior year, based on a net operating loss in a subsequent year.

Note that in this particular process, no amendment is filed for the given prior year that the refund is requested from. Section 172 (b) (A), as modified by (F) (i) and F (ii) (I), allows loss "from theft" to be carried back 3 years rather than 2 years, and then forward for 20 years. Under Regulation 1.172-4 (b) (1) the carryback and carry forward loss is always to the oldest available

year first.[2]

"Sec. 172 Net operating loss deduction

(a) Deduction allowed
There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating carrybacks and carryovers
(1) Years to which loss may be carried
(A) General rule
Except as otherwise provided in this paragraph, a net operating loss for any taxable year--
(i) shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and
(ii) shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss."

. . .

(F) Retention of 3-year carryback in certain cases
(i) In general
Subparagraph (A)(i) shall be applied by substituting "3 taxable years" for "2 taxable years" with respect to the portion of the net operating loss for the taxable year which is an eligible loss with respect to the taxpayer.

(ii) Eligible loss
For purposes of clause (i), the term "eligible loss" means--
(I) in the case of an individual, losses of property arising from fire, storm, shipwreck, or other casualty, or from theft,
(II) in the case of a taxpayer which is a small business, net operating losses attributable to federally declared disasters (as defined by subsection (h)(3)(C)(i)), and
(III) in the case of a taxpayer engaged in the trade or business of farming (as defined in section 263A(e)(4)), net operating losses attributable to such federally declared disasters.

(3.) REFUND OF PREVIOUS TAX OVERPAYMENT

Section 6511 (a) governs the maximum length of time between: (3.1) a taxpayer filing for a credit or refund of previous overpayment of taxes; and (3.2) the date that such original filing was made or paid. It allows refund for such overpayment of tax for 2005, 2006, and 2007.

"(a) Period of limitation on filing claim

Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid."

[2] Under Code Section 172 (b) (3) (C), the taxpayer can make an (irrevocable) election to not carry back, but rather carry forward first, by attaching to their Form 1040 a note to that effect.

(4.) REDUCE 2008 TAX PAYMENT FOR PREVIOUS TAX OVERPAYMENT

(4.1) Language of Section 1341

We will treat certain income of Taxpayer's brokerage account (managed by Madoff), which was reported in a prior year or years but did not in fact occur. Assume Taxpayer is required by the bankruptcy judge to restore some amount of funds he or she previously withdrew from their managed account. Then the maximum, of that certain income and such amount returned, fits the current judicial interpretation of an "item" specified in Section 1341 (a) (1) and (2). This allows Taxpayer to reduce the current year's tax payment, which corresponds to that item. In (a) (5) this reduction is specified as the greater of the reductions that would have occurred, or would occur, from removing that item from either the prior year's or the current year's reported income, respectively. Note, this does not involve filing an amendment or refund for that prior year.

"Sec. 1341 Computation of tax where taxpayer restores substantial amount held under claim of right

(a) General rule
If--
(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
(3) the amount of such deduction exceeds $3,000,
then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
(4) the tax for the taxable year computed with such deduction; or
(5) an amount equal to--
(A) the tax for the taxable year computed without such deduction, minus
(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)."

After such a reduction in tax for the current tax year is established, the net tax owed might be negative. If so, Section 1341 (b) provides that such negative amount be treated as an overpayment of tax, which can be refunded or can be credited to other tax-year taxes.

(b) Special rules
(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

The clear language of Section 1341 (a) (1) and (2) describes the group of taxpayers entitled to the tax reduction of (a) (5). It is those who:
(i.) thought they had an unrestricted right to the item in question, and
(ii.) after filing their tax return according, discovered that they did not have such right.

(4.2) Beyond the Language of Section 1341

(4.2.1) Confusing Clarity of Statutory Language with Ease of Determining Facts

The courts have long held that their interpretation of a statute should start and end with the language of the body of the statute, if it is clear. Only when it is not, should their analysis go beyond that to other sources, like legislative history and the title or headings of legislation.

Justice Harry A. Blackmun wrote for the Supreme Court[3]:

> **"***.... Rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.*
>
> *The task of resolving the dispute over the meaning of section 506(b) begins where all such inquiries must begin: with the language of the statute itself. Landreth Timber Co. v. Landreth, 471 U. S. 681, 685 (1985). In this case it is also where the inquiry should end, for where, as here, the statute's language is plain, "the sole function of the courts is to enforce it according to its terms." Caminetti v. United States, 242 U. S. 470, 485 (1917). The language before us expresses Congress' intent -- that postpetition interest be available -- with sufficient precision so that reference to legislative history and to pre-Code practice is hardly necessary.*
> .
> .
> .
> *The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters." Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982). In such cases, the intention of the drafters, rather than the strict language, controls.***"**

This decision has been cited in 143 other federal court decisions. The Eight Circuit Court of Appeals agrees with this philosophy, but declares the language of Section 1341 ambiguous because it does not provide a method for determining whether the taxpayer in question has lost a clear right. Judge Richard W. Goldberg wrote for the court, in a decision[4] that has been cited in 17 other federal court decisions:

> *".... It is true that our starting place for analysis is the language of the statute itself. See, e.g., Connecticut Nat'l. Bank v. Germain, 503 U.S. 249, 253-54 (1992); United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989). And, when the language of the statute is clear and unambiguous, our analysis also should end here. See, e.g., Davis v. Michigan Dep't. of the Treasury, 489 U.S. 803, 808, n.3 (1989); Northern States Power Co. v. United States, 73 F.3d 764, 766 (8th Cir.), cert. denied, 117 S.Ct. 168 (1996). Yet, contrary to taxpayer's argument, the relevant statutory language here is not clear. Specifically, the language of section 1341(a)(2) makes no mention of how a taxpayer or the IRS is supposed to establish that the taxpayer does not have an unrestricted right to income. That is, from the statute's terms it is entirely ambiguous as to how a taxpayer might lose his or her unrestricted right to disputed funds.*

The lack of an explicit test for that loss is not ambiguity but generality. In the absence of limitation specified in the stature, any method of losing such right is sufficient. The statue' drafters did not care how it was lost. Theft, accident, and expropriation will each accomplish the same clearly-stated condition "*that the taxpayer did not have an unrestricted right to such item or to a portion of such item".*

This last passage quoted above, confused clarity of a statutory condition (lack of an unrestricted right) with the amount of effort it must expend to determine whether the facts of any case at hand met that condition. In particular, it mistook potentially ambiguity in fact finding (whether the statutory condition was met) for ambiguity of the language specifying the condition. The task of the court was to determine, in their particular case at hand, whether the condition was satisfied or not, or even to determine that it was unable to do so. Instead the court seized on the absence of a clear test of whether a right was lost. There was no test needed in the immediate case they faced, since no one disputed the complete lack of an unrestricted right to the item in question there.

---

[3] U.S. petitioner v. Ron Pair Enterprises, Inc. respondent (Supreme Court docket 87-1043) 22 February 1989. 489 U.S. 235; 109 S. Ct. 1026; 103 L. Ed. 2d 290; 5 7 USLW 4256; 63 A.F.T.R.2d (RIA) 89-652; 89-1 U.S. Tax Cas. (CCH) P9179; 18 Bankr.Ct.Dec. 1150, Bankr. L. Rep. P 72,575; 1989 U.S. LEXIS 1041.

[4] Marshall M. Chernin; Ida Raye Chernin, appellant/cross-appellees v U.S. appellant/cross-appellee. (8th Circuit docket 97-1913) 10 July 1998. 149 F.3d 805; 98-2 U.S. Tax Cas. (CCH) P50,551; 82 A.F.T.R.2d (RIA) 98-5134; 1998 U.S. App. LEXIS 15318.

This misplaced view of ambiguity places an impossible burden on Congress in drafting legislation, and leads to absurd results. In particular, a court afflicted with such a view would render the first statute to outlaw murder, ambiguous because it did not specify a test of death. Then, the Supreme Court's doctrine in Ron Pair[3] (quoted above) would invite such a court to look beyond the body of statutory text to the legislative history and titles. Legislative history bemoaning a spate of beheadings and a title like "An Act to Reduce Beheadings" would, together, lead such a court to read the clearly-written "dead" as "beheaded".

(4.2.2) Definition of "restore"

The confusion in (4.2.1) above lead the 8th Circuit Court to look beyond the body of text of Section 1341 (a) to the title of Section 1341, where the word "restore" appears. In the third from last paragraph of Subsection II D of the decision, the Court sites the appearance of the words "restore" and "restitution" in the legislative history[5]. The court compounded the confusion above by misconstruing the meaning of "restore" in the title and the legislative history, which in turn, lead them to greatly narrow the group of taxpayers entitled to the tax reduction of (a) (5). This misconstrual is the product of a very-selective sequential appeal to two dictionaries. First, they appeal to one of several definitions of "restore" in a common dictionary:

"*See supra Section II.A., neither the TROs nor the writ of garnishment operated to repay or restore funds. Webster's Dictionary defines "repay" as "to pay back (a person)" and defines "restore" as "to give back (. . .); make restitution of." Webster's New World Dictionary 1137, 1145 (3d ed. 1988). Black's Law Dictionary in turn defines "restitution" to mean the "[a]ct or making good or giving an equivalent for or restoring something to the rightful owner." Black's Law Dictionary 1313 (6th ed. 1990). Taxpayer concedes LPP never received any funds by way of the TROs and the writ of garnishment. We therefore conclude taxpayer does not qualify for section 1341 treatment because he never repaid funds to LPP.*"

Here they have refined that definition of "restore", with one of several definitions of "restitution" in a specialized law dictionary. In doing so, the court ignored that law dictionary's[6] first definition of "restitution": "*An equitable remedy under which a person is restored to his or her original position he or she would have been, had the breach not occurred.*" But even the court's few quoted words from their chosen second definition ("*or making good*") are perfectly consistent with out Taxpayer correcting an erroneous profit and account balance.

The dictionaries cited by the 8th Circuit Court were published 34 and 36 years, respectively after the 1954 enactment of Section 1341. The statute's drafters were less likely to have consulted such a specialized dictionary, and are more likely to have intended the usage common in 1954, which is reflected in the most popular dictionaries of that time. The particular one of five definitions of "restore", cited by the court, moved from fifth to first between the 1954 edition (year of Statue's enactment) and 1988 edition[7] (year of court decision). Thus linguistic drift and the court's selectively ignoring most of the dictionary definitions given, lead the court to narrow the taxpayer group specified in Section 1341 (a) (2) by their creation of two additional conditions, that members of that group must satisfy:

(iii.) held the item in question in their possession since the prior tax year, and
(iv.) surrendered that item to another party as a result of the subsequent discovery.

---

[5] They cite H.R. Rep. No 1337 (1954) reprinted in 1954 U.S.C.A.A. N. 4017, 4113.

[6] Nolan, Joseph R. and Nolan-Haley, Jacqueline M. Black's Law Dictionary, 6th edition 1990. St. Paul, MN: West Publishing Co. ISBN-10: 031476271x.

[7] Webster's New World Dictionary of American English (3rd College edition 1988, New York: Webster's New World) ISBN 0-13-949280-1, defines "restore" as: *1. to give back (something taken away, lost, etc.); make restitution of 2. to bring back to a former or normal condition, as by repairing, rebuilding, altering. etc. [to restore a building, painting, etc.] 3. to put (a person) back in a place, position, rank, etc. [to restore a king to his throne] 4. to bring back to health, strength, etc. 5. to bring back into being, use, etc.; reestablish [to restore order, a system of government, etc.].*

The word "restore" is defined, in the two most popular dictionaries[8] of 1954, as follows:

> American College Dictionary. Clarence L. Barnhart, Editor-in-Chief. New York: Random House, 1954.
> *re-store ... v.t, -stored, -storing. 1. to bring back into existence, use, or the like; reestablish: to restore order. 2. to bring back to a former, original, or normal condition, as a building, statue, or painting. 3. bring back to a state of health, soundness, or vigor. 4. to put back to a former place, or to a former position, rank, etc. 5. to give back; make return or restitution of (anything taken away or lost). 6. to reproduce, reconstruct, or represent (an ancient building, extinct animal, etc.) in the original state.*

> Thorndike-Barnhart Comprehensive Desk Dictionary. Edited by Clarence L. Barnhart. Garden City, New York: Doubleday & Company, Inc., 1954.
> *re-store ... v., -stored, -storing. 1. bring back; establish again: restore order. 2. bring back to a former condition or to a normal condition: the old house has been restored. 3. given back; put back: restore stolen goods to the owner.*

A taxpayer in the group defined by conditions (i.) and (ii.) in (4.1) above [but not by the 8th Circuit Court additional conditions (iii.) and (iv.) immediately above], indeed satisfies the test of the court's superfluous appeal to the title of Section 1341: "*where taxpayer restores substantial amount held under claim of right".* These definitions hold for the "item" of their managed-account balance and this definition of "restore" as explained here.

Our Taxpayer's situation clearly satisfies five of the seven relevant definitions in common use in 1954, as evidenced by the two dictionary definitions above. Note, in the first dictionary, definitions 3. and 6. do not apply to the question at hand. The definition of "restore" cited in the decision is further interpreted through the word "restitution" in a specialized law dictionary[5], but there a definition that fits the Taxpayers situation is ignored for one that does not.

In the first dictionary: for Definition 1. Taxpayer did "*bring back into existence ... or the like*" and "*reestablish*" the correct value of the "item" in their managed-account's balance, i.e., from a profit back to the original and correct balance. Similarly, for Definitions 2. and 4., Taxpayer did "*bring back to a former, original, or normal condition*" and did "*put back to a former place, or to a former position"* that balance. Definition 3. is not relevant since the "item" is not alive. In the second dictionary, for Definitions 1. and 2, Taxpayer did "*bring back; establish again: restore order"* to, and "*bring back to a former condition or to a normal condition"* their account balance.

Note that the first dictionary's Definition 3. is, however, particularly instructive in this discussion. It shows that the item restored [the "item" in Section 1341 (a)] does not have to be a positive thing, but rather it can be a negative thing reversed, e.g., restoring health, which is curing ill health. The "item" restored under Section 1341 (a) is the false income (inflated account balance) reported by Madoff, that is restored or reinstated to its former accurate value. Another good analogy is to "restore" truth that was "taken away". Thus the two conditions added by the 8th Circuit Court to the group of taxpayers eligible for relief under Section 1341 (a) (2) are not required by the word restore.

The IRS position, in much litigation, is that the title of a code section is not, in general, dispositive in interpreting statues. One of the most recent of such arguments appeared in the Government briefs in the case of Cemco Investors, LLC and Forest Chartered Holding, LTD, plaintiffs-appellants, v. United States of America, respondent, in the 7th Circuit Court of Appeals Docket No. 07-2220, 515 F.3d 765, 7 February 2008, Judge Frank H. Easterbrook.

In that case, Section 6662 (e) has a title of "Substantial valuation misstatement under Chapter 1". Yet, the Government briefs applied this paragraph to an alleged basis misstatement that all parties agreed had nothing to do with valuation. The Government used that section to level a

---

[8] According to the research staff of the Library of Congress, Humanities & Social Sciences Division, who maintain the dictionary collection.

40% penalty for the mechanical application of basis rules for an asset, where the Government agreed to the taxpayer's valuation of the asset.

Congress could have limited 1341 (a) to the far-narrower sense of such items, that also meet the test of being an asset held by Taxpayer and delivered by Taxpayer to another party, but it did not.

(4.3) Capricious Result of 8th Circuit's Mistakes and Suggested Legislative Fix

Consider two hypothetical Taxpayers, Mr. A and Mr. B, who each invested $10 million ten years ago in brokerage accounts managed by Madoff. Assume each received brokerage statements showing they earned 10%/year, and each withdrew their earning and paid $0.35 million in federal income tax each year. After 10 years, suppose Mr. A: withdrew all of his $1 million balance, and was forced to return it all by the bankruptcy judge. Assume Mr. B left his $10 million in the account.

The question is: how will each fare under Section 1341. The item of annual income that Mr. A paid tax on each year clearly meets the peculiar test of 1341 (A) (2) developed in Chernin v. U.S, that is explained in (4.2.1) above. Just as clearly, none of Mr. B's tax payments meet that peculiar test. Thus following that decision: Mr. A will reduce his 2008 tax payment by ($0.35 million annual tax payment) (10 years) = $3.50 million; and Mr. B will reduce his 2008 tax payment by $0. Here we have identical circumstances, in terms of loss and tax overpayment. But the two mistakes pointed out in (4.2.1) and (4.2.2) imply capricious and very different tax results for Mr. A and Mr. B. A good fix here is for Congress to amend section 1341 (a), so it specifically states that the "item included in gross income" is not limited, by 1341 (a) (2), to any particular methods of losing the unrestricted right to that item or of discovering such. We want to preclude the 8th Circuit Court's imagination in divining ambiguity "as to how a taxpayer might" discover a loss, to borrow words from the last quotation in (4.2.1) above.

Mercifully, no other court that I can find has adopted this view of statutory interpretation in general, but the Eight Circuit Court's specific application in this case, which drastically narrow Section 1341 (a) (2), is cited in: 1 case each in the 3rd and 8th Circuit Court of Appeals, 7 cases in District Courts of the 2nd, 3rd, 4th, 5th, & 8th circuits, 1 case in the Court of Claims, and 5 cases in Tax Court.

(5.) DUELING LEGAL PARADIGMS

The losses in question are not that of a partner of a hedge fund or an investor in a mutual fund that lost money. Rather the losses are money stolen from the individual brokerage account of the victim. The stolen assets were the direct property of the victim, just as if it were money in their house that was stolen. Thus, analogies made in the press between the Madoff theft and that of the Bayou Fund thief, discovered in 2005, are misplaced. There, the victims had ownership of partnership shares of a hedge fund, which in turn, owned the stolen assets. The usual bankruptcy paradigm is appropriate for the Bayou Fund, but not for the Madoff-managed individual accounts. One does not use the usual bankruptcy paradigm for a thief that stole money from many peoples' houses, but it is fine for a partnership that is bankrupt from theft. Of course many victims of a burglar might sue the burglar, and end up in court over the now-bankrupt thief's assets, that were not stolen property.

However, the theft at hand was stealing from one client and giving it to another. Thus, in a stolen-property paradigm, the court should return the stolen property from the holder to the rightful owner. For the Madoff victims, that would be the court taking money from victims, who received out more money than they put into their accounts, and giving it (in some pro-rata manner) to those victims that took out less than they put in to their accounts. The first complicating factor is that some former victims are in foreign countries and out of reach of the court. The

second complicating factor is that there might have been some trading that made or lost money in some accounts. This would require an accounting. If that is not practical, then some rough assumption should be made, e.g., trading did not occur.

Regardless of which paradigm is applied, New York Civil Practice, Law and Rules, Article 2 Section 213(8) limits recovery for cases involving fraud to six years. Federal Courts generally respect state laws in such matters. Thus, the Federal Bankruptcy Court for the Southern District of Manhattan (which is currently handing liquidation of Madoff's broker-dealer) may seek the recovery of withdrawals in excess of contributions, or even all withdrawals, for some period of time up to six years before the theft was discovered on 11 December 2008. Individual victims may also sue to recover withdrawals, in excess of contributions, in other courts. Victims in states with shorter statutes of limitations, who the courts seek to recover funds from, may use those statutes in fighting recovery.

APPENDIX: LARCENY STATUTE OF NEW YORK STATE

§ 155.00 Larceny; definitions of terms. The following definitions are applicable to this title:

1. "Property" means any money, personal property, real property, computer data, computer program, thing in action, evidence of debt or contract, or any article, substance or thing of value, including any gas, steam, water or electricity, which is provided for a charge or compensation.

2. "Obtain" includes, but is not limited to, the bringing about of a transfer or purported transfer of property or of a legal interest therein, whether to the obtainer or another.

3. "Deprive." To "deprive" another of property means (a) to withhold it or cause it to be withheld from him permanently or for so extended a period or under such circumstances that the major portion of its economic value or benefit is lost to him, or (b) to dispose of the property in such manner or under such circumstances as to render it unlikely that an owner will recover such property.

4. "Appropriate." To "appropriate" property of another to oneself or a third person means (a) to exercise control over it, or to aid a third person to exercise control over it, permanently or for so extended a period or under such circumstances as to acquire the major portion of its economic value or benefit, or (b) to dispose of the property for the benefit of oneself or a third person.

5. "Owner." When property is taken, obtained or withheld by one person from another person, an "owner" thereof means any person who has a right to possession thereof superior to that of the taker, obtainer or withholder. A person who has obtained possession of property by theft or other illegal means shall be deemed to have a right of possession superior to that of a person who takes, obtains or withholds it from him by larcenous means. A joint or common owner of property shall not be deemed to have a right of possession thereto superior to that of any other joint or common owner thereof. In the absence of a specific agreement to the contrary, a person in lawful possession of property shall be deemed to have a right of possession superior to that of a person having only a security interest therein, even if legal title lies with the holder of the security interest pursuant to a conditional sale contract or other security agreement.

6. "Secret scientific material" means a sample, culture, micro-organism, specimen, record, recording, document, drawing or any other article, material, device or substance which constitutes, represents, evidences, reflects, or records a scientific or technical process, invention or formula or any part or phase thereof, and which is not, and is not intended to be, available to anyone other than the person or persons rightfully in possession thereof or selected persons having access thereto with his or their consent, and when it accords or may accord such rightful possessors an advantage over competitors or other persons who do not have knowledge or the benefit thereof.

7. "Credit card" means any instrument or article defined as a credit card in section five hundred eleven of the general business law. 7-a. "Debit card" means any instrument or article defined as a debit card in section five hundred eleven of the general business law. 7-b. "Public benefit card" means any medical assistance card, food stamp assistance card, public assistance card, or any other identification, authorization card or electronic access device issued by the state or a social services district as defined in subdivision seven of section two of the social services law, which entitles a person to obtain public assistance benefits under a local, state or federal program administered by the state, its political subdivisions or social services districts. 7-c. "Access device" means any telephone calling card number, credit card number, account number, mobile identification number, electronic serial number or personal identification number that can be used to obtain telephone service.

8. "Service" includes, but is not limited to, labor, professional service, a computer service, transportation service, the supplying of hotel accommodations, restaurant services, entertainment, the supplying of equipment for use, and the supplying of commodities of a public utility nature such as gas, electricity, steam and water. A ticket or equivalent instrument which evidences a right to receive a service is not in itself service but constitutes property within the meaning of subdivision one.

9. "Cable television service" means any and all services provided by or through the facilities of any cable television system or closed circuit coaxial cable communications system, or any microwave or similar transmission service used in connection with any cable television system or other similar closed circuit coaxial cable communications system.

§ 155.05 Larceny; defined.

1. A person steals property and commits larceny when, with intent to deprive another of property or to appropriate the same to himself or to a third person, he wrongfully takes, obtains or withholds such property from an owner thereof.

2. Larceny includes a wrongful taking, obtaining or withholding of another's property, with the intent prescribed in subdivision one of this section, committed in any of the following ways:

(a) By conduct heretofore defined or known as common law larceny by trespassory taking, common law larceny by trick, embezzlement, or obtaining property by false pretenses;

(b) By acquiring lost property. A person acquires lost property when he exercises control over property of another which he knows to have been lost or mislaid, or to have been delivered under a mistake as to the identity of the recipient or the nature or amount of the property, without taking reasonable measures to return such property to the owner;

(c) By committing the crime of issuing a bad check, as defined in section 190.05;

(d) By false promise. A person obtains property by false promise when, pursuant to a scheme to defraud, he obtains property of another by means of a representation, express or implied, that he or a third person will in the future engage in particular conduct, and when he does not intend to engage in such conduct or, as the case may be, does not believe that the third person intends to engage in such conduct. In any prosecution for larceny based upon a false promise, the defendant's intention or belief that the promise would not be performed may not be established by or inferred from the fact alone that such promise was not performed. Such a finding may be based only upon evidence establishing that the facts and circumstances of the case are wholly consistent with guilty intent or belief and wholly inconsistent with innocent intent or belief, and excluding to a moral certainty every hypothesis except that of the defendant's intention or belief that the promise would not be performed;

(e) By extortion. A person obtains property by extortion when he compels or induces another

person to deliver such property to himself or to a third person by means of instilling in him a fear that, if the property is not so delivered, the actor or another will: (i) Cause physical injury to some person in the future; or (ii) Cause damage to property; or (iii) Engage in other conduct constituting a crime; or (iv) Accuse some person of a crime or cause criminal charges to be instituted against him; or (v) Expose a secret or publicize an asserted fact, whether true or false, tending to subject some person to hatred, contempt or ridicule; or (vi) Cause a strike, boycott or other collective labor group action injurious to some person's business; except that such a threat shall not be deemed extortion when the property is demanded or received for the benefit of the group in whose interest the actor purports to act; or (vii) Testify or provide information or withhold testimony or information with respect to another's legal claim or defense; or (viii) Use or abuse his position as a public servant by performing some act within or related to his official duties, or by failing or refusing to perform an official duty, in such manner as to affect some person adversely; or (ix) Perform any other act which would not in itself materially benefit the actor but which is calculated to harm another person materially with respect to his health, safety, business, calling, career, financial condition, reputation or personal relationships.