Irving H. Picard v. Saul B. Katz et al
Doc. 13 Att. 7

Exhibit G

Dockets.Justia.com

10-2378-bk(L)

10-2676, 10-2677, 10-2679, 10-2684, 10-2685, 10-2687, 10-2691, 10-2693, 10-2694, 10-2718, 10-2737

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE: BERNARD L. MADOFF INVESTMENT SECURITIES LLC

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR APPELLANTS STERLING EQUITIES ASSOCIATES, ARTHUR FRIEDMAN, DAVID KATZ, GREGORY KATZ, MICHAEL KATZ, SAUL KATZ, L. THOMAS OSTERMAN, MARVIN TEPPER, FRED WILPON, JEFF WILPON, RICHARD WILPON, AND METS LIMITED PARTNERSHIP

KAREN E. WAGNER, ESQ.
BRIAN S. WEINSTEIN, ESQ.
JONATHAN D. MARTIN, ESQ.
DAVIS POLK & WARDWELL LLP
450 Lexington Avenue
New York, New York 10017
(212) 450-4000

Attorneys for Appellants Sterling Equities Associates, Arthur Friedman, David Katz, Gregory Katz, Michael Katz, Saul Katz, L. Thomas Osterman, Marvin Tepper, Fred Wilpon, Jeff Wilpon, Richard Wilpon, and Mets Limited Partnership

CORPORATE DISCLOSURE STATEMENT

In accordance with Rule 26.1 of the Federal Rules of Appellate Procedure, appellant Sterling Equities Associates states that it has no parent corporation and that no publicly held corporation owns 10% or more of its stock. Appellant Mets Limited Partnership states that it has no parent corporation, that its general partner is C.D.S. Corp., a private corporation, and that no publicly held corporation owns 10% or more of its stock.

Dated: New York, New York
August 6, 2010

DAVIS POLK & WARDWELL LLP

By: */s/ Karen E. Wagner*
Karen E. Wagner
Brian S. Weinstein
Jonathan D. Martin

450 Lexington Avenue
New York, New York 10017
(212) 450-4000
karen.wagner@davispolk.com
brian.weinstein@davispolk.com
jonathan.martin@davispolk.com

Attorneys for
Sterling Equities Associates,
Arthur Friedman, David Katz,
Gregory Katz, Michael Katz,
Saul Katz, L. Thomas Osterman,
Marvin Tepper, Fred Wilpon,
Jeff Wilpon, Richard Wilpon, and
Mets Limited Partnership

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES iii

JURISDICTIONAL STATEMENT 1

STATEMENT OF THE ISSUE ON APPEAL 1

STATEMENT OF THE CASE 2

STATEMENT OF FACTS 6

SUMMARY OF THE ARGUMENT 7

STANDARD OF REVIEW 7

ARGUMENT 8

POINT I. SIPA'S DEFINITION OF "NET EQUITY" CONTROLS 8

POINT II. "NET EQUITY" CONTROLS EVEN WHERE NO SECURITIES WERE PURCHASED 9

POINT III. THE DECISION MISINTERPRETS *NEW TIMES I* 15

POINT IV. SECTION 78fff-2(b) DOES NOT SUPPORT THE DECISION 18

POINT V. THE DECISION ALTERS SIPA'S DISTRIBUTION SCHEME 21

POINT VI. AVOIDANCE POWERS ARE IRRELEVANT 23

CONCLUSION 31

TABLE OF AUTHORITIES

PAGE

In re Bayou Group, LLC, 362 B.R. 624 (Bankr. S.D.N.Y. 2007) 27

In re Bernard L. Madoff Investment Sec. LLC, 424 B.R. 122 (Bankr. S.D.N.Y. 2010) ....passim

In re Bevill, Bresler & Schulman, Inc., 59 B.R. 353 (D.N.J. 1986) 18-19, 20

Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer Savings & Loan Ass'n, 878 F.2d 742 (3d Cir. 1989)....................29

Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504 (1st Cir. 1987) 25

Butner v. United States, 440 U.S. 48 (1979)....................21

In re Carrozzella & Richardson, 286 B.R. 480 (D. Conn. 2002)....................26

Clark v. Martinez, 543 U.S. 371 (2005) 15

Coder v. Arts, 213 U.S. 223 (1909) 28

Colautti v. Franklin, 439 U.S. 379 (1979)....................20

Conn. Nat'l Bank v. Germain, 503 U.S. 249 (1992) 8

In re Flanagan, 503 F.3d 171 (2d Cir. 2007) 7

Flickinger v. Harold C. Brown & Co., 947 F.2d 595 (2d Cir. 1991) 11

Fuentes v. Shevin, 407 U.S. 67 (1972)....................24

Grippo v. Perazzo, 357 F.3d 1218 (11th Cir. 2004) 13

Groman v. Comm'r of Internal Revenue, 302 U.S. 82 (1937)....................20

Harwood v. Int'l Estate Planners, 33 F. App'x 903 (9th Cir. 2002)....................11

HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995) 25

In re Highland Superstores Inc., 154 F.3d 573 (6th Cir. 1998) 22

In re Indep. Clearing House Co., 77 B.R. 843 (D. Utah 1987)..............................28

In re Lapiana, 909 F.2d 221 (7th Cir. 1990) 22

Lee v. Bankers Trust Co., 166 F.3d 540 (2d Cir. 1999)..8

Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935)......................24

Lowenbraun v. L.F. Rothschild, 685 F. Supp. 336 (S.D.N.Y. 1988) 11

Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit,
547 U.S. 71 (2006)..13

Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306 (1950) 24

In re New Times Sec. Servs., Inc., 371 F.3d 68 (2d Cir. 2004)........................passim

In re New Times Sec. Servs., Inc., 463 F.3d 125 (2d Cir. 2006).............................16

In re Old Naples Sec., Inc., 311 B.R. 607 (M.D. Fla. 2002) 17-18

Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981)...13

Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15 (2000) 22

Saboundijian v. Bank Audi, 157 A.D.2d 278,
556 N.Y.S.2d 258 (1st Dep't 1990)...11

Scalp & Blade, Inc. v. Advest, Inc., 309 A.D.2d 219,
765 N.Y.S.2d 92 (4th Dep't 2003) 11

SEC v. Zandford, 535 U.S. 813 (2002) 13

In re Sharp Int'l Corp., 403 F.3d 43 (2d Cir. 2005) 25-27

Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.,
191 A.D.2d 86, 599 N.Y.S.2d 816 (1st Dep't 1993)...26

In re Unified Commercial Capital, 260 B.R. 343
(Bankr. W.D.N.Y. 2001)..27

In re Unified Commercial Capital, Nos. 01-MBK-6004L, 01-MBK-6005L, 2002 WL 32500567 (W.D.N.Y. 2002) 26

United States v. Noland, 517 U.S. 535 (1996) 21, 22

United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213 (1996) 22

United States v. Sec. Indus. Bank, 459 U.S. 70 (1982) 24

Visconsi v. Lehman Bros., 244 F. App'x 708 (6th Cir. 2007) 11

In re W. World Funding, 54 B.R. 470 28

Wright v. Union Cent. Life Ins., 304 U.S. 502 (1938) 24

Statutes & Rules

11 U.S.C. § 362(b)(6) 29

11 U.S.C. § 362(b)(7) 29

11 U.S.C. § 362(b)(17) 29

11 U.S.C. § 362(b)(27) 29

11 U.S.C. § 362(o) 29

11 U.S.C. § 510(c) 22

11 U.S.C. § 544 25

11 U.S.C. § 546(e) 29

11 U.S.C. § 546(f) 29

11 U.S.C. § 546(g) 29

11 U.S.C. § 546(j) 29

11 U.S.C. § 547 28

11 U.S.C. § 548(a)(1)(A) 25

11 U.S.C. § 548(a)(1)(B) 25

11 U.S.C. § 548(d)(2)(A) 25

11 U.S.C. § 555 29

11 U.S.C. § 556 29

11 U.S.C. § 559 29

11 U.S.C. § 560 29

11 U.S.C. § 561 29

11 U.S.C. § 562 29

11 U.S.C. § 741 *et seq.* 13, 20

11 U.S.C. § 741(6) 20

11 U.S.C. § 749(b) 29

11 U.S.C. § 753 29

11 U.S.C. § 764(b) 29

11 U.S.C. § 767 29

15 U.S.C. § 78aaa *et seq.* 1

15 U.S.C. § 78eee(b)(4) 1

15 U.S.C. § 78fff-2(b) 18-20

15 U.S.C. § 78fff-2(c)(1) 18

15 U.S.C. § 78fff-2(c)(1)(B) 3, 22

15 U.S.C. § 78fff-3(a) 3

15 U.S.C. § 78*lll*(11) .... passim

17 C.F.R. § 240.10b-10 (2010) 12

28 U.S.C. § 158(d)(2)(A) 1

Fed. R. Bankr. P. 7001(1) 24

Fed. R. Bankr. P. 7004(a) 24

Fed. R. Bankr. P. 7012 24

Fed. R. Bankr. P. 7013 24

N.Y. Debt. & Cred. Law § 272 25

N.Y. Debt. & Cred. Law § 273 25

NASD Rule 2340 12

NYSE Rule 409 12

NYUCC Art. 8 Historical and Statutory Notes (McKinney 2002) 10

NYUCC § 8-102(a)(9)(i) 10

NYUCC § 8-102(a)(14) 10

NYUCC § 8-102(a)(17) 10

NYUCC § 8-112(c) 11

NYUCC § 8-501 cmt. 2 11

NYUCC § 8-501 cmt. 3 12

NYUCC § 8-501 *et seq.* 10

NYUCC § 8-501(b) 10

NYUCC § 8-501(c) 11

Other Authorities

5 *Collier on Bankruptcy* § 547.01
(Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2010) 27

5 *Collier on Bankruptcy* § 548.01[1][a]
(Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) 24

Confirmation of Transactions, 59 Fed. Reg. 59,612 (Nov. 17, 1994)......................12

FINRA, If a Brokerage Firm Closes Its Doors 14

H.R. Rep. No. 95-746 (1977)...14

Nat'l Ass'n of Sec. Dealers, Notice 92-30:
Proposed Amendment to Rules of Fair Practice to
Require Members to Send Periodic Statements of
Account to Customers (July 22, 1992) 13

S. Rep. No. 95-763 (1978) 14

SIPC, SIFMA & NASAA,
Understanding Your Brokerage Account Statements 12, 14

SIPC, SIPC Exposes Phony "Look-Alike" Web Site Targeting
Madoff Victims (Mar. 9, 2010) 14

JURISDICTIONAL STATEMENT

The United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") has jurisdiction over this proceeding pursuant to 15 U.S.C. § 78eee(b)(4). This Court has jurisdiction over this direct appeal pursuant to 28 U.S.C. § 158(d)(2)(A).

On March 19, 2010, Appellants Sterling Equities Associates, Arthur Friedman, David Katz, Gregory Katz, Michael Katz, Saul Katz, L. Thomas Osterman, Marvin Tepper, Fred Wilpon, Jeff Wilpon, Richard Wilpon, and Mets Limited Partnership (together, the "Sterling Customers" (Docket No. 10-2693)) timely filed a notice of appeal from a final order of the Bankruptcy Court dated March 8, 2010. On April 7, 2010, the Sterling Customers timely transmitted a Joint Petition for Permission to Appeal, and this Court granted the petition on June 16, 2010.

STATEMENT OF THE ISSUE ON APPEAL

Under the Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq.* ("SIPA"), customer "net equity" claims against a failed broker are determined by:

> "(A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer . . . ; minus
>
> (B) any indebtedness of such customer to the debtor on the filing date[.]" 15 U.S.C. § 78*lll*(11).

Did the Bankruptcy Court err when it ruled that SIPA's "net equity" definition may be ignored in a SIPA proceeding precipitated by a massive fraud in which the broker failed to purchase securities shown on customer account statements?

STATEMENT OF THE CASE

This is an appeal from an order of the United States Bankruptcy Court for the Southern District of New York (Hon. Burton R. Lifland) dated March 8, 2010 (the "Order"), based upon a Memorandum Decision issued on March 1, 2010 (the "Decision"). The Decision holds that, in this case, which involves "astounding sums" and an "incogitable scheme," the broker's failure to purchase customer securities warranted departure from the statutory "net equity" definition in favor of an *ad hoc* "Net Investment Method" that disregards the broker's obligation to the customer on the filing date. *See In re Bernard L. Madoff Investment Sec. LLC*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010) ("*In re BLMIS*").

Nature of the Case

This case arises out of the substantively consolidated SIPA liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS") and Bernard L. Madoff ("Madoff"). BLMIS was a broker registered with the United States Securities and Exchange Commission (the "SEC") and a member of the Securities Investor Protection Corporation ("SIPC").

On December 11, 2008, the SEC filed a civil complaint in the United States District Court for the Southern District of New York alleging that BLMIS and Madoff operated a fraudulent scheme through BLMIS's investment advisory business. *See In re BLMIS*, 424 B.R. at 126. On December 15, 2008, the District Court granted SIPC's application for an order commencing a proceeding under SIPA, appointing a trustee (the "Trustee") and removing the proceeding to the Bankruptcy Court. *See id.*

SIPC is an independent, nonprofit membership corporation created by SIPA. SIPC is required to support a fund (the "SIPC Fund") to be used to advance money to a SIPA trustee. After a registered broker's failure, "customer property" is to be distributed ratably to customers "on the basis and to the extent of their respective net equities." 15 U.S.C. § 78fff-2(c)(1)(B). If a customer's "net equity" exceeds its ratable share of customer property, the customer is entitled to an advance from the SIPC Fund, and the SIPC trustee is directed to advance money from the SIPC Fund "[i]n order to provide for prompt payment and satisfaction of net equity claims of customers." *See* 15 U.S.C. § 78fff-3(a); *see also In re BLMIS*, 424 B.R. at 133.

The parties agree that BLMIS customers are "customers" within the meaning of SIPA and that they have "claims for securities" entitling each account to an advance of up to $500,000 from the SIPC Fund against their net equity claim. *In re BLMIS*, 424 B.R. at 135 and n.28.

SIPA defines "net equity" as "the dollar amount of the account or accounts of a customer, to be determined by calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer," less "any indebtedness of such customer to the debtor on the filing date." 15 U.S.C. § 78*lll*(11).

Procedural History

On December 23, 2008, the Bankruptcy Court entered a claims procedure order governing the filing, determination, and adjudication of claims in the BLMIS liquidation proceeding. *In re BLMIS*, 424 B.R. at 126. The order required that customers submit written statements of claim to the Trustee. The Trustee was then to determine their treatment, and customers were permitted to object and seek judicial review. *Id.*

Based on SIPA's definition of "net equity," the Sterling Customers filed written statements of claim for the market value of the securities reflected on their last account statements, which were dated November 30, 2008. The Trustee rejected the claims, ruling that the Sterling Customers were entitled to nothing. His determination was based not on the statutory "net equity" definition but upon the Trustee's so-called "Net Investment Method" – a calculation of the difference

over the life of each account between the total sum the customer deposited with BLMIS and the total sum withdrawn.

The Sterling Customers filed timely objections to the Trustee's determinations.

The Bankruptcy Court's Decision

On September 16, 2009, the Bankruptcy Court entered an order establishing a briefing schedule limited to the legal issue of "the proper interpretation of 'net equity.'" Joint Appendix ("J.A.") Vol. I at 267. All rights were reserved as to other issues, and no fact-finding process was anticipated in the order or undertaken by the parties or the Court.

After briefing and argument, the Bankruptcy Court issued the Decision on March 1, 2010, and the Order on March 8. Special Appendix ("S.A.") 7; S.A. 60.

Citing this Court's decision in *New Times Sec. Servs., Inc.*, 371 F.3d 68 (2d Cir. 2004) ("*New Times I*"), the Bankruptcy Court asserted that "net equity" may be "susceptible to differing formulations" depending upon the "underlying factual disparities" of a broker's fraud. *In re BLMIS*, 424 B.R. at 137. Concluding that "[t]he BLMIS books and records expose a Ponzi scheme where no securities were ever ordered, paid for or acquired," *id.* at 135, the Court decided that departure from the "net equity" definition was warranted in this case.

The Bankruptcy Court further held that the Net Investment Method was "consistent with the Trustee's statutory avoidance powers," *id.*, even though no avoidance action was before the Court. In effect, the Bankruptcy Court supported the Trustee's unilateral determination, without recourse to any process, that transfers by BLMIS to its customers before the filing were broadly void, and therefore the statutory "net equity" definition should be displaced. The Court dismissed as "hypothetical" and "irrelevant" the existence of defenses to avoidance claims. *Id.* at 136.

STATEMENT OF FACTS

The only facts relevant to the issue before the Court are not in dispute.

Each of the Sterling Customers executed a Customer Agreement, a Trading Authorization, and an Option Agreement with BLMIS. The agreements gave Madoff investment discretion. J.A. Vol. I. at 547, 549.

BLMIS brokerage account 1KW300 held by Sterling Equities Associates ("SEA") is an example. SEA regularly deposited funds for the purpose of purchasing securities, usually by sending a check drawn on a bank to BLMIS, and withdrew funds when its statement reflected available cash proceeds of sales. SEA received confirmations of deposits and transactions, and monthly account statements that reflected transactions, securities held, and available cash. The last account statement SEA received states that, as of November 30, 2008, SEA's account was

credited with ownership of stock in numerous real companies – including Wal-Mart, Exxon Mobil, Coca-Cola, Intel, and Pfizer. J.A. Vol. I at 552-56.

SUMMARY OF THE ARGUMENT

Under SIPA, a customer's "net equity" claim is determined by reference to the sum which would have been owed by the broker to the customer on the filing date. That sum is established by the customer's last account statement, the primary document upon which customers rely to establish their ownership of securities. The Bankruptcy Court erred when it substituted the "Net Investment Method," which disregards customer statements, based on its conclusion that no securities were ever purchased in this Ponzi scheme. Under SIPA, as under other laws regulating the securities markets, customer statements are the foundation by which a broker's obligation to its customer is established. Claims based on such statements are entitled to SIPA protection, regardless of either the broker's purchase of securities or the nature and extent of the broker's fraud.

The Decision and Order should be reversed.

STANDARD OF REVIEW

This Court reviews *de novo* the Bankruptcy Court's legal conclusions, including its interpretation of SIPA. *See In re Flanagan*, 503 F.3d 171, 179 (2d Cir. 2007); *New Times I*, 371 F.3d at 75.

ARGUMENT

POINT I.

SIPA'S DEFINITION OF "NET EQUITY" CONTROLS

The interpretation of "net equity" starts and ends with the plain language of the statute. "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'" *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) (internal citations omitted); *see also Lee v. Bankers Trust Co.*, 166 F.3d 540, 544 (2d Cir. 1999) ("It is axiomatic that the plain meaning of a statute controls its interpretation . . . and that judicial review must end at the statute's unambiguous terms.").

The definition of "net equity" in SIPA is unambiguous:

> "The term 'net equity' means the dollar amount of the account or accounts of a customer, to be determined by –
>
> (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer . . . ; minus
>
> (B) any indebtedness of such customer to the debtor on the filing date[.]" 15 U.S.C. § 78*lll*(11).

The definition of "net equity" requires that a customer's claim against a failed broker be calculated by valuing the securities "owed" to the customer on the filing date, deducting only indebtedness of the customer to the broker as of that

date. It imposes no obligation that the customer prove the actual purchase of securities listed on the customer's statement.

The Sterling Customers' November 30, 2008 account statements – the last account statements that BLMIS issued before the December 11, 2008 filing date – reflect the securities positions that BLMIS owed them as of that date. None of the Sterling Customers was indebted to BLMIS. Accordingly, the Sterling Customers' "net equity" under SIPA is the dollar amount that BLMIS would have owed the Sterling Customers if the securities positions reflected on their account statements had been liquidated on December 11, 2008.

POINT II.

"NET EQUITY" CONTROLS EVEN WHERE NO SECURITIES WERE PURCHASED

The Trustee ignored the statutory definition. Instead, he devised the Net Investment Method, and determined that BLMIS – and the SIPC Fund – owed the Sterling Customers nothing. The Bankruptcy Court sustained his methodology because "[t]he BLMIS books and records expose a Ponzi scheme where no securities were ever ordered, paid for or acquired." *See In re BLMIS*, 424 B.R. at 135.

But there is no statutory support – and the Bankruptcy Court cited none – for the proposition that the broker's failure to buy securities owed to the customer, as established by the customer's statements, somehow means the broker is no longer obligated for those securities. Rather, SIPA reflects the rules that govern the

operation of the securities markets, under which a broker is obligated to the customer for the securities listed on the customer's statements and confirmations – whether or not the broker actually buys them.

In New York, Article 8 of the New York Uniform Commercial Code ("NYUCC") governs the obligations of a broker to its customer, and the rights of the customer against the broker. *See* NYUCC § 8-501 *et seq.*[1] Under Article 8, the broker's obligation to the customer is created by the issuance of a statement. Section 8-501(b) of the NYUCC provides that "a person acquires a security entitlement[2] if a securities intermediary[3] . . . (1) indicates by book entry that a financial asset has been credited to the person's security account." It is therefore "a basic operating assumption of the indirect holding system that once a [broker] has acknowledged that it is carrying a position in a financial asset for the customer

[1] Article 8 addresses the modern securities holding system, in which customers do not hold physical certificates, but rather hold securities entitlements in an indirect holding system. *See, e.g.*, "Legislative Intent and Declaration" accompanying the enactment of Article 8 in New York:

> "The legislature finds and declares that a revised article eight of the uniform commercial code is needed to provide clarity and certainty regarding the rules that govern how interests in securities are evidenced and how they are transferred in the current securities market. The existing law fails to clearly define such rules when an interest is held through an intermediary, rather than by holding a certificate or by registration with the issuer of securities." NYUCC Art. 8 Historical and Statutory Notes (McKinney 2002).

[2] A "security entitlement" means "the rights and property interest of an entitlement holder with respect to a financial asset [including a security, *see* NYUCC § 8-102(a)(9)(i)] specified in Part 5 [of Article 8]." NYUCC § 8-102(a)(17).

[3] A "securities intermediary" includes a broker. *See* NYUCC § 8-102(a)(14).

. . . the [broker] is obligated to treat the customer . . . as entitled to the financial asset." *See* NYUCC § 8-501 cmt. 2.[4]

Once the acknowledgment is reflected on a statement, Section 8-501(c) provides that "a person has a securities entitlement even though the securities intermediary does not itself hold the financial asset" – i.e., the broker owes the customer the securities reflected on the customer's statement regardless of whether the broker actually purchased the securities. As the Official Comment to this Section explains:

> "In the indirect holding system, the significant fact is that the securities intermediary has undertaken to treat the customer as entitled to the financial asset. It is up to the securities intermediary to take the necessary steps to ensure that it will be able to perform its undertaking."

* * * * *

[4] A customer has an enforceable claim against its broker for the securities on its account statements. *See* NYUCC § 8-112(c); *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595, 599-600 (2d Cir. 1991) ("Brown, in sum, breached its contract with Flickinger when it failed to deliver the securities to him."); *Visconsi v. Lehman Bros.*, 244 F. App'x 708, 713-14 (6th Cir. 2007) ("Plaintiffs gave $21 million to [the broker], not to hide under a rock or lock in a safe, but for the express purpose of investment, with a hope – indeed a reasonable expectation – that it would grow. . . . [T]he fictitious statements issued by Lehman, which were designed to track Plaintiffs' funds as if they had been properly invested, indicate that Plaintiffs' accounts would have grown to more than $37.9 million . . . . Plaintiffs thus . . . were entitled to the full $37.9 million balance shown, regardless of the amounts of their previous deposits and withdrawals."); *see also Harwood v. Int'l Estate Planners*, 33 F. App'x 903, 906 (9th Cir. 2002); *Scalp & Blade, Inc. v. Advest, Inc.*, 309 A.D.2d 219, 765 N.Y.S.2d 92 (4th Dep't 2003).

In addition, New York law provides that a "broker who has discretionary powers over an account owes his client fiduciary duties," *Lowenbraun v. L.F. Rothschild*, 685 F. Supp. 336, 343 (S.D.N.Y. 1988), breach of which gives rise to a claim for damages. *See Saboundijian v. Bank Audi*, 157 A.D.2d 278, 284, 556 N.Y.S.2d 258 (1st Dep't 1990).

> "The entitlement holder's rights against the securities intermediary do not depend on whether or when the securities intermediary acquired its interests." NYUCC § 8-501 cmt. 3.

Article 8 is consistent with the bedrock principle of federal broker-dealer regulation that brokers are to issue statements, upon which customers may rely, to evidence customer transactions and holdings.[5] Thus, Rule 10b-10 under the Securities Exchange Act of 1934 (the "1934 Act") requires brokers to provide customers with confirmations of securities transactions. *See* Rule 10b-10, 17 C.F.R. § 240.10b-10 (2010) (Confirmation of Transactions). Similarly, the rules of the Financial Industry Regulatory Authority ("FINRA") and the New York Stock Exchange ("NYSE") require brokers to provide periodic account statements. NASD Rule 2340 (Customer Account Statements); NYSE Rule 409 (Statements of Accounts to Customers). A customer's account statements show, among other things, its trading activity and current securities positions.

These customer documents are intended to "serve[] basic investor protection functions," by "allowing investors to verify the terms of their transactions . . . [and] acting as a safeguard against fraud."[6] Confirmation of Transactions, 59 Fed. Reg.

[5] A joint publication by SIPC, the Securities Industry and Financial Markets Association ("SIFMA"), and the North American Securities Administrators Association ("NASAA"), titled *Understanding Your Brokerage Account Statements*, tells customers of broker-dealers that "[y]our account statement will . . . tell you the market value of securities you own – at the beginning and end of the period covered – so you can decide whether to buy more, sell, or simply hold your position." J.A. Vol. II at 133.

[6] Federal securities law protects customers' claims for securities shown on their statements, whether or not they were purchased. "[A] broker who accepts payment for securities

59,612, 59,613 (Nov. 17, 1994). Account statements inform customers of "the status of their securities positions" and provide a "safeguard against errors and misunderstandings between [brokerage firms] and customers." Nat'l Ass'n of Sec. Dealers, Notice 92-30: Proposed Amendment to Rules of Fair Practice to Require Members to Send Periodic Statements of Account to Customers (July 22, 1992).[7]

The primary role played by customer account statements does not change when a broker is in a SIPA proceeding. SIPA is a key part of the same overall system of securities regulation intended to "promot[e] investor confidence in the securities markets and protect[] broker-dealer customers." *See New Times I*, 371 F.3d at 86, 87. *See generally* 11 U.S.C. § 741 *et seq*. Customers in a SIPA case are entitled to rely "on what the customer has been told by the debtor in written confirmations." *New Times I*, 371 F.3d at 86. Indeed, SIPC expressly advises customers that, in the event a broker fails, they should use their account statements to prove what the broker owed them:

> "In the unlikely event your brokerage firm fails, you will need to prove that cash and/or securities are owed to you. This is easily done with a copy of your most recent statement and transaction records of the items

---

that he never intends to deliver . . . violates § 10(b) and Rule 10b-5." *SEC v. Zandford*, 535 U.S. 813, 819 (2002); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 n.10 (2006); *Grippo v. Perazzo*, 357 F.3d 1218, 1223-24 (11th Cir. 2004). Any violation gives rise to damages. *See, e.g.*, *Osofsky v. Zipf*, 645 F.2d 107, 114 (2d Cir. 1981) (applying benefit-of-the-bargain damages under the 1934 Act).

[7] *Available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1695&print=1 (last visited Aug. 6, 2010).

> bought or sold after the statement." SIPC, et al., *Understanding Your Brokerage Account Statements*, J.A. Vol. II at 137.

The SIPC Fund was established precisely because Congress recognized that securities may be missing when a broker becomes insolvent.[8] SIPA's legislative history explains that Congress was aware that securities belonging to customers of a defunct broker might be missing for a variety of reasons, both nefarious and not, including the broker's failure to purchase such securities:

> "Under present law, because securities belonging to customers may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, it is not always possible to provide to customers that which they expect to receive, that is, securities which they maintained in their brokerage account. . . . By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments . . . would satisfy the customers' legitimate expectations . . . ." J.A. Vol. III at 326 (emphasis added).

> "A customer generally expects to receive what he believes is in his account at the time the stockbroker ceases business. But because securities may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, this is not always possible. Accordingly, [when this is not possible, customers] will receive cash based on the market value as of the filing date . . . ." J.A. Vol. I at 617 (emphasis added).

[8] SIPC describes itself as "the U.S. investor's first line of defense in the event a brokerage firm fails, *owing customer cash and securities that are missing from customer accounts.*" *E.g.*, SIPC, SIPC Exposes Phony "Look-Alike" Web Site Targeting Madoff Victims (Mar. 9, 2010) (emphasis added), *available at* http://www.sipc.org/media/release09Mar10.cfm (last visited Aug. 6, 2010). Similarly, FINRA's website states that "SIPC insurance comes into play in those rare cases of firm failure *where customer assets are missing because of theft or fraud*." FINRA, If a Brokerage Firm Closes Its Doors, http://www.finra.org/Investors/protectyourself/investoralerts/P116996 (last visited Aug. 6, 2010) (emphasis added).

The Decision turns this entire system on its head. The Bankruptcy Court ruled that the account statements upon which the indirect holding system depends become useless exactly when they are most needed – when a broker fails due to fraud. Nothing in SIPA supports that conclusion. A result less likely to reinforce the confidence that investors have in the U.S. securities markets is hard to imagine.

POINT III.

THE DECISION MISINTERPRETS *NEW TIMES I*

The Bankruptcy Court decided that different rules should apply in this case because of the nature and scope of Madoff's fraud, finding that "underlying factual disparities make the definition of Net Equity susceptible to differing formulations," citing this Court's decision in *New Times I*. *See In re BLMIS*, 424 B.R. at 137. But *New Times I* does not stand for "the dangerous principle that judges can give the same statutory text different meanings in different cases." *Clark v. Martinez*, 543 U.S. 371, 386 (2005). Such an approach "would render every statute a chameleon," *id.* at 382, and has never been the law of this Circuit.

In any event, *New Times I* supports the application of "net equity" in this case. New Times was a broker that, like BLMIS, engaged in a Ponzi scheme in which no securities were acquired. Most New Times customers received account statements showing investments in real securities. *New Times I*, 371 F.3d at 71-72. In the subsequent SIPA liquidation of New Times, no one disputed that these

claimants had net equity claims equal to the market value of the securities reflected on their account statements, even though the broker never purchased them and even though the statements reflected fictitious payments. *See id.* at 74.

Other New Times customers, however, received account statements showing investments in non-existent securities – the issuers were imaginary. *See id.* at 71-72. "To be clear – and this is the crucial fact in this case – the New Age Funds in which the Claimants invested *never* existed." *Id.* at 74 (emphasis in original). Based in part upon SEC rules providing that "whether a claim is treated as one for securities or cash depends not on what is *actually* in the customer's account but on what the customer has been told by the debtor in written confirmations, " this Court ruled that these customers nevertheless had claims for securities. *Id.* at 86 (emphasis in original).

However, it was impossible to apply the valuation required by the "net equity" definition to these securities – not because the securities were never purchased, as was true of all of them, but because "the securities in question did not exist and, thus, could not be liquidated or replaced by the Trustee." *Id.* at 76; *see also In re New Times Sec. Servs., Inc.*, 463 F.3d 125, 129-30 (2d Cir. 2006) ("*New Times II*") (noting that it was "impossible to reimburse customers with the actual securities or their market value on the filing date (the usual remedies when customers hold specific securities)"). Therefore, valuing these securities posed an

interstitial question not addressed by SIPA. It was only in the context of a fact pattern where the statute could not be applied as written that this Court approved a net investment approach.

The blue chip securities found on the BLMIS customer statements – such as Wal-Mart, Exxon Mobil, Coca-Cola, Intel and Pfizer – are real and can easily be valued, and so do not present the same conundrum. However, the Bankruptcy Court wrongly concluded that these securities should be likened to the imaginary *New Times* securities because the positions on the BLMIS statements were "artificially constructed" by backdating trades and were "entirely divorced from the uncertainty and risk of actual market trading." *In re BLMIS*, 424 B.R. at 139-40.[9]

The Bankruptcy Court's conclusion is unsupported. In *New Times I* this Court held that there is a critical difference between "non-existent *transactions*" and "non-existent *securities*." 371 F.3d at 86 (emphasis in original).[10] The "net

---

[9] The Bankruptcy Court cited an alleged trading price discrepancy for one security and the fact that another – the Fidelity Spartan U.S. Treasury Money Market Fund – changed its name. *See In re BLMIS*, 424 B.R. at 130, 139 n.34; J.A. Vol. I at 540. But, particularly where the broker has discretion and is a fiduciary, SIPA does not require that a customer confirm the status of each security on every statement. The "goal of greater investor vigilance" is not one of SIPA's purposes. *New Times I*, 371 F.3d at 87. In any event, even if a single security on a statement full of otherwise-traded blue chips was incorrectly named, that error cannot support a departure from the "net equity" definition and the *New Times I* decision.

As no evidentiary process was employed, these "findings," like others relied upon by the Bankruptcy Court, were improperly made, but in all events none of them affects the substance of the legal dispute at issue – how "net equity" is determined under SIPA.

[10] The Bankruptcy Court's reliance on *In re Old Naples Securities, Inc.*, 311 B.R. 607 (M.D. Fla. 2002), is misplaced. *See In re BLMIS*, 424 B.R. at 140 n.35. That case involved

equity" definition can readily be applied to securities positions on customer statements whether or not any *transactions* occurred; it is only where the *securities* themselves do not exist that the statute provides no valuation criteria. As the securities on the BLMIS customer statements have ascertainable market values, *New Times I* – and SIPA itself – require that the statutory definition of "net equity" be employed to determine customer claims.

POINT IV.

SECTION 78fff-2(b) DOES NOT SUPPORT THE DECISION

Instead of applying the statutory "net equity" definition, the Bankruptcy Court adverted to an irrelevant phrase in an unrelated section to bolster its support for the Trustee's approach. But that phrase supports the application of the "net equity" definition and the determination of a customer's claim based on its account statement.

Section 78fff-2(b) of SIPA provides that a trustee is promptly to discharge the obligations of the defunct broker to its customers by distributing the securities or cash owed to each customer.[11] The phrase upon which the Bankruptcy Court

---

"claims for cash," so the court did not have to determine whether the securities at issue could be "liquidated by sale or purchase on the filing date." *See In re Old Naples*, 311 B.R. at 616. Moreover, just as in *New Times I*, the securities at issue in *Old Naples* were imaginary and had no ascertainable market value on the filing date. *See id.* at 613.

[11] The provision addresses "the *qualitative* distribution of customer property, that is, the manner of payment of each customer's share of the customer property fund." *In re Bevill, Bresler & Schulman, Inc.*, 59 B.R. 353, 362-63 (D.N.J. 1986) (emphasis added). By contrast, Section 78fff-2(c)(1), which requires a trustee to pay customers ratably "on the basis and to the

relied, italicized below, requires that a customer demonstrate whether the broker owed it securities or cash, so that the trustee can distribute the requisite form of compensation to the customer. Section 78fff-2(b) reads, in relevant part:

> "**Payments to Customers**. After receipt of a written statement of claim pursuant to subsection (a)(2), the trustee shall promptly discharge, in accordance with the provisions of this section, all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by the delivery of securities or the making of payments to or for the account of such customer (subject to the provisions of subsection (d) and section 9(a) [15 U.S.C. § 78fff-3(a) of this title]) *insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee*. For purposes of distributing securities to customers, all securities shall be valued as of the close of business on the filing date." 15 U.S.C. § 78fff-2(b) (emphasis added).

Patently, neither the italicized phrase nor the entire section requires proof that the broker bought the securities owed to the customer – they require proof only of the broker's "*obligation*" to the customer. Consequently, before now no court has ever concluded that Section 78fff-2(b) requires the customer to prove that securities were actually purchased. Indeed, the panel in *New Times I*, where the calculation of certain net equity claims was directly at issue, did not even refer to Section 78fff-2(b).

And that is not surprising, since "net equity" is defined in Section 78*lll*(11). "[A] definition which declares what a term 'means' . . . excludes any meaning that

extent of their respective net equities," "describes the *quantitative* distribution of customer property, that is, the share of the aggregate fund of customer property to which each customer is entitled." *Id.* at 362 (emphasis added).

is not stated." *Colautti v. Franklin*, 439 U.S. 379, 392 n.10 (1979) (internal quotation marks omitted); *see also Groman v. Comm'r of Internal Revenue*, 302 U.S. 82, 86 (1937) ("[W]hen an exclusive definition is intended the word 'means' is employed[.]").

That a customer's claim should be calculated based upon the *obligation* of the broker is also confirmed by reference to Subchapter III of Chapter 7 of the Bankruptcy Code, which governs bankruptcy of non-registered brokers. *See* 11 U.S.C. § 741 *et seq*. Under Chapter 7, unlike SIPA, no provision is made for distribution of securities to customers, so Chapter 7 has no analogue to Section 78fff-2(b). Yet the definition of "net equity" in each statute is substantively the same, *compare* 11 U.S.C. § 741(6) *with* 15 U.S.C. § 78*lll*(11), and it has been held that Subchapter III and SIPA differ only in "the qualitative distribution of customer property," not the "quantitative distribution of customer property." *See In re Bevill, Bresler & Schulman, Inc.*, 59 B.R. 353, 362, 369 (D.N.J. 1986).

Here, the Bankruptcy Court and the Trustee agree that the BLMIS customers are SIPA "customers" with claims for securities, based on the customers' account statements. *See In re BLMIS*, 424 B.R. at 135 and n.28. The same statements evidence BLMIS's obligation to them on the filing date. No further proof is required by Section 78fff-2(b), which does not in any event vary the statutory "net equity" definition.

POINT V.

THE DECISION ALTERS SIPA'S DISTRIBUTION SCHEME

The Net Investment Method alters the customer's right under SIPA both to ratably share in customer property and to receive an advance from the SIPC Fund. To support its affirmation of the Net Investment Method, the Decision invokes "equity and practicality." *In re BLMIS*, 424 B.R. at 140. But Congress has already decided how equity and practicality are to be resolved in the treatment of customer claims under SIPA. When Congress has so spoken, "undefined considerations of equity" can play no role in determining customers' claims in bankruptcy. *Butner v. United States*, 440 U.S. 48, 55-56 (1979). "Decisions about the treatment of claims in bankruptcy proceedings . . . are not dictated or illuminated by principles of equity . . . ." *See United States v. Noland*, 517 U.S. 535, 540-41 (1996) (internal quotation marks omitted).

The Decision improperly varies SIPA's mandate in at least two ways. First, it redefines "net equity" by replacing it with the Net Investment Method. Once Congress has defined how a claim in bankruptcy is to be determined, neither a bankruptcy court nor anyone else is "authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors'

entitlements."[12] *Raleigh v. Ill. Dep't of Revenue,* 530 U.S. 15, 24-25 (2000); *see also In re Highland Superstores, Inc*., 154 F.3d 573, 579 (6th Cir. 1998) (a court may not "sweep aside [substantive] law – in favor of general equitable principles – in computing [a creditor's] claim"); *In re Lapiana*, 909 F.2d 221, 224 (7th Cir. 1990) ("[B]ankruptcy judges are not empowered to dissolve rights in the name of equity.").

Second, the Decision ignores SIPA's mandate that a customer's net equity claim be calculated *as of the filing date*, and claims so calculated are to share ratably in customer property. *See* 15 U.S.C. § 78fff-2(c)(1)(B). Under the Net Investment Method, claims are calculated by reference to a customer's transfers in and out over the life of the account, in order to "bring[] the greatest number of investors closest to their positions prior to Madoff's scheme," *In re BLMIS*, 424 B.R. at 142, resulting in each claim being calculated at a different point in time. The Net Investment Method therefore is an improper "categorical reordering of priorities that takes place at the legislative level." *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 229 (1996) (holding that bankruptcy courts may not rank claims within the class of general unsecured creditors in the name of equity).

---

[12] Under principles of equitable subordination, bankruptcy trustees may seek to subordinate a particular claim based on the inequitable conduct of a specific creditor. *See* 11 U.S.C. § 510(c); *Noland*, 517 U.S. at 540. A bankruptcy trustee may not, however, subordinate a *class* of claims based "on the supposedly general unfairness of satisfying [those claims]." *Noland*, 517 U.S. at 541.

POINT VI.

AVOIDANCE POWERS ARE IRRELEVANT

Finally, the Bankruptcy Court justified its approval of the Net Investment Method by commenting that it was "consistent with the Trustee's statutory avoidance powers," because "transfers made in furtherance of a Ponzi scheme, and specifically transfers of fictitious profits, are avoidable." *In re BLMIS*, 424 B.R. at 135-36. The existence of legal or factual defenses was found to be irrelevant.

> "The fact that the Trustee may be unable to avoid a transfer in particular circumstances . . . is irrelevant to the Court's finding that the power itself is inconsistent with a distribution scheme that credits the reported products of a fraud. The Net Investment Method allows the definition of Net Equity and the Trustee's powers to avoid and recover property, contained in the same statutory framework, to be interpreted with preferred consonance." *Id.* at 136-37.

But there is no "consonance." The definition of "net equity" says nothing about any power to avoid and recover property. The possible existence generally of claims for avoidance against customers, and even the existence of avoidance claims against a particular customer, are simply not criteria relevant to the definition, which permits "net equity" to be reduced only by indebtedness to the broker on the filing date.

And, the transfers by BLMIS to its customers are not void.

First, no avoidance power has properly been invoked in this case. To use the avoidance provisions, a trustee must employ mandatory process, including

commencement of an adversary proceeding, in part so that the target of an avoidance action may assert defenses.[13] Here, the Bankruptcy Court itself observed that "no avoidance action is currently pending," to explain why the Court declined to reach the merits of any defenses to avoidance. *In re BLMIS*, 424 B.R. at 136 and n.30. But that is exactly the point – in the absence of such process, the conclusion that BLMIS transfers before the filing date may be considered void by the Trustee on a unilateral and wholesale basis is wholly improper.

Second, transfers to valid creditors are not avoidable as fraudulent. The purpose of fraudulent transfer law is to ensure that an insolvent debtor does not, intentionally or otherwise, reduce the pool of assets available to creditors by transferring assets for less than fair value.[14] Therefore,

---

[13] *See* Fed. R. Bankr. P. 7001(1). These rules import most of the Federal Rules of Civil Procedure, including the requirement that summons and complaint be served, and the provisions for asserting defenses and counterclaims. *See* Fed. R. Bankr. P. 7004(a), 7012, 7013.

SIPA does not permit the Trustee simply to make a unilateral determination of voidability – and if it did SIPA would run afoul of constitutional due process protections and takings prohibitions. *See, e.g.*, *Fuentes v. Shevin*, 407 U.S. 67 (1972) (due process mandates a hearing before property can be taken); *Mullane v. Cent. Hanover Bank & Trust Co*., 339 U.S. 306, 314 (1950) ("An elementary and fundamental requirement of due process" is "an opportunity to present . . . objections."); *Wright v. Union Central Life Ins*., 304 U.S. 502, 518 (1938) ("[Congress] may authorize the bankruptcy court to affect these property rights, provided the limitations of the due process clause are observed."); *United States v. Sec. Indus. Bank*, 459 U.S. 70, 75 (1982) ("The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation."); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.").

[14] Any transfer, intentional or not, that has the effect of "unfairly draining the pool of assets available to satisfy creditors' claims" may be avoided. 5 *Collier on Bankruptcy* § 548.01[1][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); *see also* 11 U.S.C.

> "the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because '[t]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them.'" *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995) (quoting *Boston Trading Group, Inc. v. Burnazos*, 835 F.2d 1504, 1509 (1st Cir. 1987)).

A payment made to discharge an enforceable debt, such as BLMIS's obligation to its customers, is a transfer for value that is not avoidable as fraudulent.[15]

The Decision contends to the contrary that the payments by BLMIS over the years were invalid because Madoff was engaged in a fraud. But this Court has held that any such proposition is invalid. In *In re Sharp International Corp.*, 403 F.3d 43 (2d Cir. 2005), State Street, a lender to Sharp, began to suspect Sharp of fraud and demanded that Sharp repay its loan. Sharp fraudulently induced investments from unsuspecting investors, which were then used to repay State Street. *See id.* at 47-48. This Court ruled that Sharp's payment to State Street constituted a preference, but not a fraudulent conveyance. A "'conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another.'"

---

§§ 548(a)(1)(A) (federal intentional fraud provision), 548(a)(1)(B) (federal constructive fraud provision), 544 (importing state law); N.Y. Debt. & Cred. Law § 273 (New York fraudulent transfer provision).

[15] *See* 11 U.S.C. § 548(d)(2)(A) (defining "value" to include the "satisfaction or securing of a present or antecedent debt of the debtor"); N.Y. Debt. & Cred. Law § 272 (providing that fair consideration is given when "an antecedent debt is satisfied").

Id. at 54 (quoting *Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.*, 191 A.D.2d 86, 90-91, 599 N.Y.S.2d 816 (1st Dep't 1993)).

That Sharp used funds from defrauded investors to pay State Street, just as occurs in a Ponzi scheme, did not change the fact that the transfer to the lender "was at most a preference between creditors and did not 'hinder, delay, or defraud either present or future creditors.'" *Id.* at 56.

> "The nub of the complaint is that State Street knew that there would likely be victims of the [Sharp principals'] fraud, and arranged not to be among them. On the one hand, this seems repugnant; on the other hand, [the lender's] discovery that Sharp was rife with fraud was an asset of State Street, and State Street had a fiduciary duty to use that asset to protect its own shareholders, if it legally could. One could say that State Street failed to tell someone that his coat was on fire; or one could say that it simply grabbed a seat when it heard the music stop. The moral analysis contributes little." *Id.* at 52.

Other courts have recognized that a payment to an innocent creditor in a Ponzi scheme cannot be avoided as fraudulent if the payment satisfied an antecedent debt. For example, in *In re Carrozzella & Richardson*, 286 B.R. 480 (D. Conn. 2002), also a Ponzi scheme case, creditors had a contractual right to both the principal and the profits that the debtor had transferred to them. The court thus concluded that payment of profits could not be avoided as fraudulent, because "[i]n exchange for the [profits] paid to the Defendants, the Debtor received a dollar-for-dollar forgiveness of a contractual debt." *Id.* at 491; *see also In re Unified Commercial Capital*, Nos. 01-MBK-6004L, 01-MBK-6005L, 2002 WL 32500567,

at *8 (W.D.N.Y. June 21, 2002) (rejecting trustee's effort to claw back profits from "an innocent investor, who has received a bargained-for, contractual interest payment, at a commercially reasonable rate"); *In re Unified Commercial Capital*, 260 B.R. 343, 351 (Bankr. W.D.N.Y. 2001).

Nor can the so-called "Ponzi scheme presumption" serve as a legal foundation for the Decision. *See In re BLMIS*, 424 B.R. at 136 and n.29. The facts of *Sharp* were legally indistinguishable from those characterizing a Ponzi scheme. Consequently, after *Sharp* no "Ponzi scheme presumption" may be the basis for concluding that transfers on account of antecedent debt – even in the course of a Ponzi scheme – are avoidable simply because the transferor was engaged in a fraud.[16]

By paying legally enforceable debts, BLMIS did not reduce the amount available to pay creditors – it simply paid one over another. Such a payment cannot be avoided as fraudulent, but only, if at all, as preferential. "A preference involves payment of a debt that violates the bankruptcy principle of equal distribution among all creditors." 5 *Collier on Bankruptcy* § 547.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2010). A fraudulent transfer goes further. As the

---

[16] Such a presumption may have some relevance where a transfer is made to someone other than a creditor, for example the redemption of an equity interest. *See, e.g.*, *In re Bayou Group, LLC*, 362 B.R. 624, 638 (Bankr. S.D.N.Y. 2007) (equity holders – as opposed to creditors – of the fraudulent enterprise did not have contractual antecedent debt "[i]n contrast to the lawful and disclosed payment of a valid contractual antecedent debt in *Sharp*"). But where a transfer is made to discharge a valid antecedent debt, bad intent as to that transfer cannot be presumed, and in any event is irrelevant, as the creditor body as a whole has not been harmed.

Supreme Court long ago cautioned, "[a]n attempt to prefer is not to be confounded with an attempt to defraud, nor a preferential transfer with a fraudulent one." *Coder v. Arts*, 213 U.S. 223, 241 (1909) (internal quotation marks omitted).

Third, even were these payments subject to avoidance as preferential, the preference provision permits avoidance only of transfers made within ninety days before a bankruptcy filing, and that period may not be enlarged. *See* 11 U.S.C. § 547; *see also In re Indep. Clearing House Co.*, 77 B.R. 843, 855 (D. Utah 1987) ("The equitable powers of the bankruptcy court are limited by the express terms of the Code. . . . In the absence of any statutory or judicial precedent, . . . the court may not invoke its equitable powers to substantively enlarge the trustee's avoiding powers as urged in this case." (internal quotation marks omitted)); *see also In re W. World Funding,* 54 B.R. 470, 476 n.2 (D. Nev. 1985) ("The Court's equitable powers are limited by the express provisions of the Code. Section 547 is intended to promote equality of distribution, and 'it is no reflection on the statute that it does not do so entirely.'" (internal citation omitted)).

Since avoidance of transfers extending further back than the preference period is barred, avoidance law cannot be the basis of any legal conclusion that any payments by BLMIS outside of the preference period are void.

Finally, payments made by brokers in connection with securities contracts are protected from most avoidance theories. Because Congress has recognized that

the capital markets cannot function unless transfers are protected from some of the contingencies of bankruptcy, the Bankruptcy Code excepts many types of securities transactions from some of its rules.[17] *See Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer Savings & Loan Ass'n*, 878 F.2d 742, 751 (3d Cir. 1989) (Section 546 is at the intersection of "two important national legislative policies [bankruptcy and securities law] . . . on a collision course"). Section 546(e) is one of these protective provisions.

Section 546(e) provides, in relevant part:

> "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer . . . that is a transfer made by or to . . . [a] stockbroker [or] financial institution, . . . in connection with a securities contract, as defined in section 741(7), . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(e).

This section shields from avoidance any transfer by a broker in connection with a securities contract, unless the transfer is otherwise avoidable and made with fraudulent intent, within two years of a filing. Very few transfers, if any, by a broker to a bona fide customer will fall outside of this protection. The policy served by this provision is entirely consistent with the laws generally regulating the securities markets, including SIPA, which are intended to protect customers and encourage investment.

---

[17] *See, e.g.*, 11 U.S.C. §§ 362(b)(6),(7),(17) & (27), 362(o), 546(e),(f),(g) & (j), 555, 556, 559, 560, 561, 562, 749(b), 753, 764(b), 767.

The abandonment in the Decision of the "net equity" definition is not supported by the assumption that vast avoidance powers exist with respect to payments by BLMIS to its customers. Any such powers are extremely limited, and are entirely independent of the definition of "net equity."

CONCLUSION

For the reasons stated above, the Sterling Customers respectfully request that this Court reverse the Decision and Order and hold that the Sterling Customers' "net equity" under SIPA is what BLMIS owed the Sterling Customers, which is the securities on their statements, or their value, as of the filing date.

Dated: New York, New York
August 6, 2010

DAVIS POLK & WARDWELL LLP

By: */s/ Karen E. Wagner*
Karen E. Wagner
Brian S. Weinstein
Jonathan D. Martin

450 Lexington Avenue
New York, New York 10017
(212) 450-4000
karen.wagner@davispolk.com
brian.weinstein@davispolk.com
jonathan.martin@davispolk.com

Attorneys for
Sterling Equities Associates,
Arthur Friedman, David Katz,
Gregory Katz, Michael Katz,
Saul Katz, L. Thomas Osterman,
Marvin Tepper, Fred Wilpon,
Jeff Wilpon, Richard Wilpon, and
Mets Limited Partnership

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS AND TYPE STYLE REQUIREMENTS

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 7,986 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in size 14 Times New Roman font.

Dated: New York, New York
August 6, 2010

DAVIS POLK & WARDWELL LLP

By: */s/ Karen E. Wagner*
Karen E. Wagner
Brian S. Weinstein
Jonathan D. Martin

450 Lexington Avenue
New York, New York 10017
(212) 450-4000
karen.wagner@davispolk.com
brian.weinstein@davispolk.com
jonathan.martin@davispolk.com

Attorneys for
Sterling Equities Associates,
Arthur Friedman, David Katz,
Gregory Katz, Michael Katz,
Saul Katz, L. Thomas Osterman,
Marvin Tepper, Fred Wilpon,

Jeff Wilpon, Richard Wilpon, and
Mets Limited Partnership