Irving H. Picard v. Saul B. Katz et al Doc. 28

Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800

*Attorneys for the Sterling Defendants*

**UNITED STATES BANKRUPTCY COURT**
**SOUTHERN DISTRICT OF NEW YORK**

| | |
|---|---|
| SECURITIES INVESTOR PROTECTION CORPORATION,<br><br>Plaintiff-Applicant,<br><br>- against -<br><br>BERNARD L. MADOFF INVESTMENT SECURITIES LLC,<br><br>Defendant. | Adv. Pro. No. 08-01789 (BRL)<br><br>SIPA LIQUIDATION<br><br>(Substantively Consolidated) |
| In re:<br><br>BERNARD L. MADOFF,<br><br>Debtor. | |
| IRVING H. PICARD,<br><br>Plaintiff,<br><br>- against -<br><br>SAUL B. KATZ, et al.<br><br>Defendants. | Adv. Pro. No. 10-05287 (BRL) |

**NOTICE OF RECENT AUTHORITY**

Dockets.Justia.com

The Sterling Defendants respectfully submit this notice of recent authority to inform the Court of two recent decisions that further support the Sterling Defendants' pending motion to dismiss the amended complaint or, in the alternative, for summary judgment ("Sterling Motion") and that reject arguments advanced by the Trustee and SIPC.

## I. Bankruptcy Code Section 546(e) Must Be Afforded Its Plain Meaning

In *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, No. 09-5122-bk(L), 2011 U.S. App. LEXIS 13177 (2d Cir. June 28, 2011) ("*Enron*"), attached hereto as Exhibit A, the United States Court of Appeals for the Second Circuit ruled that transfers sought to be avoided as fraudulent or preferential—Enron's pre-petition payments to redeem its own commercial paper prior to maturity—were "settlement payments" exempted from avoidance under the plain meaning of the Bankruptcy Code's statutory safe harbor, 11 U.S.C. § 546(e) ("Section 546(e)"), and the definition of "settlement payment" under 11 U.S.C. § 741(8). The Court emphasized the breadth of the Section 546(e) safe harbor, which was advocated by the Securities and Exchange Commission ("SEC") as *amicus curiae*. *Enron*, 2011 U.S. App. LEXIS 13177, at *3-4, *15-19. Because the Court found Section 546(e)'s language unambiguous, its analysis began and ended with its plain meaning. In particular, the Court rejected the argument that Section 546(e) did not apply because the "systemic risks that motivated Congress's enactment of the safe harbor" were not implicated by the redemption of commercial paper, noting as to the analogous risk presented by a leveraged buyout that "undoing long-settled leveraged buyouts would have a substantial impact on the stability of the financial markets, even though *only* private securities were involved and *no* financial

intermediary took a beneficial interest in the exchanged securities during the course of the transaction." *Id.* at *26-27 (emphasis added).

The Sterling Motion involves a later, and even more broadly worded, iteration of Section 546(e). Applying the Second Circuit's plain meaning interpretation to the current language of Section 546(e) mandates application of the safe harbor to the transfers the Trustee seeks to avoid in his Complaint. Further, the rejection by the Circuit of the claim that Section 546(e) cannot apply where "none of the potential disruptions to the market occasioned by undoing settled purchases and sales . . . could or would occur" equally requires rejection of the argument that the safe harbor cannot apply in this case because BLMIS traded no securities. (Trustee Opp. at 90-91; *see also* SIPC Opp. at 17-18.)

## II. Avoidance of BLMIS Transfers Requires Complicity in Madoff's Fraud

A decision from New York's highest state court, *Commodity Futures Trading Commission v. Walsh*, No. 91, 2011 N.Y. LEXIS 1704 (N.Y. June 23, 2011) ("*Walsh*"), attached hereto as Exhibit B, further supports the Sterling Defendants' position that a transfer may not be avoided as fraudulent where consideration is given unless participation in the fraud can be established. In *Walsh*, the New York Court of Appeals decided two questions certified to it by the Second Circuit to help resolve a dispute between the ex-wife of an alleged fraudster and the Commodity Futures Trading Commission ("CFTC") and the SEC, who sought disgorgement from the ex-wife of the proceeds of her husband's fraud that were transferred to her as part of the couple's divorce settlement. *Id.* at *1-2. The wife argued that she was entitled to retain the transferred property because she was an innocent and unknowing recipient of the assets for which she gave fair consideration. *Id.* at *5-6. In response to the certified questions,

the New York Court of Appeals held (i) that proceeds of fraud *can* become "marital property" under New York law and (ii) that a spouse *can* provide "fair consideration" for such marital assets, precluding disgorgement. *Id.* at *11, *20.

To conclude that the proceeds of fraud can become marital property, the Court of Appeals relied on the long-standing principle of New York law that "money obtained by fraud or felony cannot be followed by the true owner into the hands of one who has received it bona fide and for a valuable consideration in due course of business." *Id.* at *12 (quoting *Stephens v. Bd. of Educ. of Brooklyn*, 79 N.Y. 183, 186 (1879)). Such a principle is grounded in "New York's concern for finality in business transactions":

> "[T]o permit in every case of the payment of a debt an inquiry as to the source from which the debtor derived the money, and a recovery if shown to have been dishonestly acquired, would disorganize all business operations and entail an amount of risk and uncertainty which no enterprise could bear." *Id.* at *13 (quoting *Banque Worms v. BankAmerica Int'l*, 77 N.Y.2d 362, 372 (1991)).

Although *Walsh* was not a fraudulent transfer case, the principles applied by the Court of Appeals apply here to undercut any argument that the transfers by BLMIS to its customers were transfers of "other people's money" that can be recovered as intentional fraudulent transfers. Because money is fungible, it cannot be followed into an innocent party's hands—it can be followed only into the hands of a participant in a fraud. *See id.* at *12-13 & n.5. As the New York Court of Appeals stated, it was not "unsympathetic to the interests of parties who were fraudulently deprived of their investments and who, understandably, seek the return of a portion of their stolen monies," but the victims of a fraud can pursue disgorgement only where it is demonstrated that the transferee was "aware of or participated in the fraud or otherwise failed to act in good faith," such as by

colluding to enter into a divorce agreement intended to conceal money from its rightful owner. *Id.* at *21-22.

Dated: New York, New York
July 1, 2011

DAVIS POLK & WARDWELL LLP

By: s/ Karen E. Wagner
Karen E. Wagner
Dana M. Seshens

450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800

*Attorneys for the Sterling Defendants*

Of Counsel:
Robert B. Fiske, Jr.
Robert F. Wise, Jr.