UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, *et al.*, Defendants.	Adv. Pro. No. 10-05287 (BRL) Case No. 1:11-cv-03605-JSR

SUPPLEMENTAL MEMORANDUM OF LAW OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO STERLING DEFENDANTS' MOTION TO DISMISS OR, IN THE ALTERNATIVE, FOR SUMMARY JUDGMENT

SECURITIES INVESTOR PROTECTION CORPORATION
805 Fifteenth Street, N.W., Suite 800
Washington, D.C. 20005
Telephone: (202) 371-8300
JOSEPHINE WANG
General Counsel
KEVIN H. BELL
Senior Associate General Counsel for Dispute Resolution
CHRISTOPHER H. LAROSA
Associate General Counsel
LAUREN T. ATTARD
Staff Attorney

Dockets.Justia.com

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES ii

STATEMENT OF THE ISSUE 1

STATEMENT OF THE CASE 2

A. Nature of the Case 2

B. Statement of Facts 4

1. The Nature of the Relationship 4

2. The Warning Signs 6

SUMMARY OF THE ARGUMENT 8

ARGUMENT 10

I. THE DEFENDANTS ARE LIABLE, INTER ALIA, UNDER SECTION 548(a)(1)(A) OF THE BANKRUPTCY CODE AND SECTION 276 OF THE NYDCL, UNLESS THEY CAN PROVE "GOOD FAITH" 10

II. UNDER THE BANKRUPTCY CODE AND THE NYDCL, "GOOD FAITH" IS PART OF AN AFFIRMATIVE DEFENSE AND THUS SHOULD NOT BE DETERMINED ON A MOTION TO DISMISS 12

A. The Standards Governing "Good Faith" Under the Bankruptcy Code and the NYDCL Are Comparable 13

III. SIPA DOES NOT ALTER SECTION 548(c)'s "GOOD FAITH" STANDARD 15

IV. SECTION 548(c)'s "GOOD FAITH" STANDARD IS COMPARABLE TO FEDERAL AND STATE LAW STANDARDS APPLICABLE TO THE DEFENDANTS PRIOR TO THE BLMIS LIQUIDATION 19

CONCLUSION 25

TABLE OF AUTHORITIES

CASES: **PAGE**

In re Adler, Coleman Clearing Corp., 198 B.R. 70 (Bankr. S.D.N.Y. 1996) 12, 15, 17

In re Adler, Coleman Clearing Corp., 218 B.R. 689 (Bankr. S.D.N.Y. 1998) 18

In re A.R. Baron Co., Inc., 226 B.R. 790 (Bankr. S.D.N.Y. 1998)...17

In re Bayou Group, LLC, 439 B.R. 284 (S.D.N.Y. 2010) 10-14, 22

In re Bernard L. Madoff Investment Securities LLC, 424 B.R. 122
(Bankr. S.D.N.Y. 2010), appeal pending, No. 10-2378 (2d Cir.) 18

In re Best Products, Inc., 68 F.3d 26 (2d Cir. 1995) 17

Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1991)..22

City of Pontiac Gen. Emps. Ret. Sys. v. MBIA, Inc., 637 F.3d 169 (2d Cir. 2011).......................21

Crigger v. Fahnestock & Co., 443 F.3d 230 (2d Cir. 2006).. 21-22

In re Dreier LLP, 2011 WL 2412581 (Bankr. S.D.N.Y. June 16, 2011) 10-14, 24

Drexel Burnham Lambert Group, Inc. v. Galdari, 1987 WL 6164
(S.D.N.Y. Jan. 29, 1987)..18

Fezzani v. Bear, Stearns & Co., 592 F.Supp.2d 410 (S.D.N.Y. 2009)...23

First Capital Investment Holdings LLC v. Wilson Capital Group, Inc.,
2011 WL 2119737 (S.D.N.Y. May 23, 2011) 23

First Lincoln Holdings, Inc. v. Equitable Life Assurance Society of U.S.,
43 Fed.Appx. 462 (2d Cir. 2002)..21

Gredd v. Bear Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.),
359 B.R. 510 (Bankr. S.D.N.Y. 2007)*, aff'd., in part, and rev'd,*
in part, 397 B. R. 1 (S.D.N.Y. 2007)..11

Grumman Allied Indus., Inc. v. Rohr Indus., Inc., 748 F.2d 729 (2d Cir. 1984)..........................23

Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1997)...21

HBE Leasing Corp. v. Frank, 61 F.3d 1054 (2d Cir. 1995) 12, 14

TABLE OF AUTHORITIES
(cont.)

CASES: **PAGE**

Hill v. Spencer Savings & Loan Assoc. (*In re Bevill, Bresler & Schulman)*, 83 B.R. 880 (D.N.J. 1988) 16

Hill v. Spencer Savings & Loan Assoc. *(In re Bevill, Bresler & Schulman, Inc.),* 94 B.R. 817 (D.N.J. 1989) 17

Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406 (S.D.N.Y. 2001) 11, 15

Kosovich v. Metro Homes, LLC, 2009 WL 5171737 (S.D.N.Y. Dec. 30, 2009) 23

In re Manhattan Inv. Fund Ltd., 397 B.R. 1 (S.D.N.Y. 2007) 14

Merck & Co. v. Reynolds, __ U. S. __, 130 S.Ct. 1784 (2010) 21

Miller v. Harding, 2000 WL 1792990 (1st Cir. Dec. 5, 2000) 23

Picard v. Merkin (In re Bernard L. Madoff Investment Secs. LLC), 440 B.R. 243 (Bankr. S.D.N.Y. 2010) 13

Picard v. Taylor (In re Park South Securities, LLC), 326 B.R. 505 (Bankr. S.D.N.Y. 2005) 17

In re PSINet, Inc., 271 B.R. 1 (Bankr. S.D.N.Y. 2001) 17

In re Refco Secs. Lit., 759 F.Supp.2d 301 (S.D.N.Y. 2010) 14

SEC v. Albert & Maguire Sec. Co., 378 F.Supp. 906 (E. D. Pa. 1974) 9

SEC v. S.J. Salmon & Co., 375 F. Supp. 867 (S.D.N.Y. 1974) 11, 15, 17

In re Sharp Int'l Corp., 403 F.3d 43 (2d Cir. 2005) 11

SIPC v. Ambassador Church Finance/Development Group, Inc., 788 F.2d 1208 (6th Cir.), *cert. den. sub nom.*, *Pine Street Baptist Church v. SIPC*, 479 U.S. 850 (1986) 15

Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc., 412 F.3d 103 (2d Cir. 2005) 22

TABLE OF AUTHORITIES
(cont.)

CASES: **PAGE**

In re Stratton Oakmont, Inc., 239 B.R. 698 (S.D.N.Y. 1999),
aff'd, 210 F.3d 420 (2d Cir. 2000) 12, 15, 17

Trefny v. Bear Stearns Secs. Corp., 243 B.R. 300 (S.D. Tex. 1999) 16

U. S. v. DiPascali, Case No. 09 CR 764 (EJS) (S.D.N.Y.) 3

STATUTES AND RULES:

Securities Investor Protection Act, as amended, 15 U.S.C. §

78bbb..................19
78fff(b)..................2, 15
78fff-1(a)..................2
78fff-2(c)(1)..................17, 18
78fff-2(c)(3)..................2, 9, 15, 16, 17
78*lll*(4)..................2

United States Bankruptcy Code, 11 U.S.C. §

544(b)..................3
547..................2
548..................1, 3, 9
548(a)..................1
548(a)(1)..................10
548(a)(1)(A)..................8, 11, 12, 13
548(c)..................1, 8-10, 12-14, 15, 19, 22-24
550(a)(2)..................14
550(b)(1)..................14

SIPC Rules, 17 C.F.R. §300.

100..................4
503(a)..................18, 19

TABLE OF AUTHORITIES
(cont.)

STATUTES AND RULES: **PAGE**

Rules of the Securities and Exchange Commission, 17 C.F.R. §240.

10b-5 ....9, 10, 19, 20, 23
10b-10 ....19, 20

N.Y. Debtor and Creditor Law §

272....................12, 13
273....................3, 13
274....................3, 13
275....................3, 13
276....................3, 8, 10, 11, 12, 23, 24
278....................3, 9, 10
278(1) 12, 23, 24
278(a) 13
279....................3, 10

N.Y. Civil Procedure Law and Rules §

213(8) 3

TREATISE:

6 *Collier on Bankruptcy* ¶ 749.02 (16th ed. 2011) 17

OTHER:

59 Fed. Reg. 59,612 (Nov. 17, 1994)....................20

Pursuant to this Court's order of July 5, 2011, the Securities Investor Protection Corporation ("SIPC") submits this supplemental memorandum of law in opposition to Defendants' motion to dismiss the amended complaint ("Complaint") or in the alternative, for summary judgment ("Motion"). This adversary proceeding arises in the context of the liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS" or "Debtor") under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. ('SIPA").[1]

STATEMENT OF THE ISSUE

SIPC addresses herein the following issue, raised by the Court at the July 1, 2011 hearing held on the Defendants' motion to withdraw the reference of this adversary proceeding:

> Under section 548(c) of the Bankruptcy Code (11 U.S.C.), a transferee may retain an interest in property that is the subject of an avoidable transfer under section 548(a) if, among other things, the transferee has taken in good faith. The issue at hand is whether SIPA modifies the applicability, or the standard, of good faith under section 548(c), notwithstanding that, to the extent consistent with SIPA, the SIPA proceeding is to be "conducted in accordance with, and as though it were being conducted" like an ordinary bankruptcy liquidation, SIPA expressly confers upon the SIPA trustee the power to avoid transfers, in particular, of customer property, provisions of the Bankruptcy Code apply to a SIPA case which include, among others, section 548, and in any event the standard of good faith under section 548(c) is the same or comparable to state and federal law standards to which some of the Defendants were subject prior to the commencement of the liquidation.

SIPC respectfully submits that SIPA does not modify the good faith standard under section 548(c) and that the standard under section 548(c) applies in a SIPA case, but under the facts alleged in this case, the Defendants did not take the transfers, which were of customer property, in good faith.

---

[1] For convenience, references to provisions of SIPA shall omit "15 U.S.C."

STATEMENT OF THE CASE

A. Nature of the Case

Under SIPA section 78fff(b), unless inconsistent with SIPA, a SIPA proceeding is to be conducted in accordance with the provisions of the Bankruptcy Code that apply to an ordinary bankruptcy liquidation, and as though the proceeding were being conducted as an ordinary bankruptcy liquidation. Thus, at a minimum, the SIPA trustee has all of the powers of a trustee in a Title 11 case, including specifically the power to avoid transfers, and in particular, the power to avoid transfers of "customer property." See SIPA §§78fff-1(a) and 78fff-2(c)(3). Under SIPA section 78lll(4), customer property includes property that was received, acquired or held by the broker-dealer for the accounts of customers and that has been unlawfully converted. For purposes of recovery in avoidance, such customer property is deemed to be property of the debtor. See SIPA § 78fff-2(c)(3).

Substantial transfers were made by the broker-dealer in this case, BLMIS, to the Defendants. Because the principal of the firm, Bernard Madoff ("Madoff"), ran a Ponzi Scheme, monies transferred to the Defendants by BLMIS consisted of stolen customer funds and therefore, "customer property." In this proceeding, the Trustee for the liquidation of BLMIS ("Trustee") seeks to avoid only the transfers that he is empowered to under the Bankruptcy Code ("Code"), made applicable by SIPA. These are garden variety avoidable bankruptcy transfers consisting of $700 million of "principal," but actually comprising stolen customer property, that were made to the Defendants or their subsequent transferees during the avoidance periods established under the Code. These transfers include: 1) preferential transfers under section 547 of the Code, 11 U.S.C. §547, that were made on or within 90 days of the filing of the application

for a SIPA customer protective decree ("SIPA Application"); 2) fraudulent conveyances under section 548 of the Code, 11 U.S.C. §548, made within two years of the filing of the SIPA Application; and/or 3) fraudulent transfers made within six years of the filing of the SIPA application and avoidable under section 544(b) of the Code, 11 U. S. C. §544(b), and provisions of New York State law. See §§ 273-279 of the N. Y. Debtor and Creditor Law ("NYDCL"), and N. Y. Civil Procedure Law and Rules ("NYCPLR") §213(8). Additionally, the Trustee seeks to avoid another $300 million of transfers of stolen customer funds by the Debtor to the Defendants or their subsequent transferees on some or all of the aforementioned grounds. These amounts were the purely fictitious profits received by the Defendants on "trades" that were never placed for them, the "trades" having been invented by Madoff to produce such fake profits as he wanted the Defendants to receive.[2] These transfers extend beyond the six-year look-back period as permitted under section 544(b) of the Code and NYCPLR §213(8).

Although certain of the Defendants had a professional relationship with Madoff that spanned nearly 25 years, the Trustee does not seek to recapture the transfers of principal that were made to them beyond the statutory avoidance periods. Nevertheless, the length of the relationship is relevant. The long-term nature of the relationship and its scope enabled the

---

[2] As Frank DiPascali, Jr., a chief Madoff confederate, testified:

> On a regular basis I used hindsight to file historical prices on stocks then I used those prices to post purchase of [sic] sales to customer accounts as if they had been executed in realtime. On a regular basis I added fictitious trade data to account statements of certain clients to reflect the specific rate of earn return that Bernie Madoff had directed for that client.

Transcript of Aug. 11, 2009 Plea Proceeding at 47, filed in U. S. v. DiPascali, Case No. 09 CR 764 (EJS) (S.D.N.Y.).

Defendants to gain insight into Madoff and his operations. In the face of such knowledge, the actions of the Defendants, as alleged in the Complaint, are proof of the Defendants' lack of good faith, and their inability, therefore, to establish good faith as a defense to the Trustee's fraudulent conveyance claims against them.

B. Statement of Facts

1. The Nature of the Relationship

The facts of this case are discussed in the main briefs opposing the Motion and are briefly examined here as a predicate to analyzing the question at hand.

As alleged by the Trustee, investments or dealings with Madoff and BLMIS cut across all lines of the real estate, sports, communications, private equity and hedge fund, empire of Sterling Equities ("Sterling"), the partnership founded by Defendants Saul Katz and Fred Wilpon. C-¶ 654.[3] Over time, the Sterling partners established 483 accounts at BLMIS for themselves and others, and from their accounts, they benefitted mightily.[4] The fictitious BLMIS "investments" generated consistent and above-market "profits" -- at least on paper -- that provided a steady flow of cash for Sterling businesses, as 90% of Sterling's investments were kept at BLMIS during much of the association. C-¶¶ 662, 677, 742. The risk-free returns created accounts for the Defendants at BLMIS that were nominally flush with cash which the

---

[3] References herein to paragraphs of the Complaint are to "C-¶ ___."

[4] The establishment of multiple accounts allegedly was, in part, driven initially by a desire to stay within the SIPA limit of $500,000 of protection per customer. See C-¶¶ 770, 771. Whether the accounts in all instances genuinely belonged to the accountholders is unclear. For example, the Trustee asserts that Saul Katz and Fred Wilpon had access to the accounts in the names of their wives, yet withdrew funds from those accounts to satisfy their personal and business obligations. See C-¶ 684. Multiple accounts that in fact belong to the same customer, albeit established in someone else's name for the sole purpose of increasing the protection, are aggregated and eligible for only up to one $500,000 protection. See SIPC Series 100 Rules, 17 C.F.R. §300.100 et seq.

Sterling Defendants used in many ways: by withdrawing funds from the Defendants' BLMIS accounts and depositing them into a Sterling bank entity for use in the Sterling businesses (C-¶¶ 701, 807–814); by touting the impressive gains in the BLMIS accounts as proof of Sterling's financial stability in order to induce refinancing of Sterling enterprises (C-¶¶ 699, 802); by using the funds as collateral to negotiate loans for major business deals (C-¶¶ 815, 816, 847); or simply by withdrawing the funds for direct use in the Sterling businesses (C-¶782). Through these uses, the BLMIS accounts and thus, the money of other BLMIS customers, enabled the Sterling businesses to develop, be sustained, and prosper.

The Defendants exploited the returns, unabashedly capitalizing on them to double their "profits." Thus, for example, using the funds in their BLMIS accounts as collateral, the Defendants obtained bank loans, deposited the loan proceeds into their BLMIS accounts, and thereby doubled their BLMIS returns. Sterling created special entities for the limited purpose of doubling returns. C-¶¶ 820-829. These "double-up" accounts almost consistently experienced profitable returns even when the markets were not. C-¶ 837.

Madoff himself invested roughly $12 million in Sterling-related businesses, but always in the name of his wife, Ruth, even though Ruth had no business dealings with Sterling. The money for these investments allegedly came from BLMIS. C-¶¶ 780, 773.

The fact that Sterling was heavily vested in the success of Madoff and BLMIS provided a powerful incentive to the Defendants to ignore signs of wrongdoing. Indeed, Sterling's fate was so completely intertwined with that of Madoff that when the BLMIS fraud was revealed, Sterling immediately experienced a severe liquidity crisis, requiring it to restructure with bank lenders over half a billion dollars in collective debt. C-¶¶ 790, 853. Yet, as described by the Trustee,

while BLMIS operated, the signals, which were unabating and persistent, incited the Sterling Defendants to do nothing.

2. The Warning Signs

When Saul Katz's son expressed concern over Sterling's concentration of investment through BLMIS, a hedge fund, Sterling Stamos, was created in 2002 as an alternative investment vehicle to BLMIS designed to replicate the BLMIS profits. BLMIS customer funds provided some of the start-up capital for the venture. C-¶¶ 706, 712, 713, 868. Once the hedge fund was underway and having performed its due diligence, Sterling Stamos personnel assertedly repeatedly warned Sterling partners about Madoff. Their concerns derived from the hedge fund's inability to generate Madoff's consistent returns, the secrecy concerning his strategy, the self-custodying and self-clearing of his operations, the persistent rumors of his front-running or illegally placing trades based on advance information, and his use of a three-man audit firm. C-¶ 869. Despite such repeated warnings, the Sterling partners ignored the advice, made no attempt to confirm the information, and continued to invest through Madoff. C-¶¶ 706, 731, 873, 880-896.

Sterling Stamos's concerns about Madoff were reinforced to Sterling by Merrill Lynch ("Merrill") when Merrill acquired an interest in the Sterling Stamos hedge fund in 2007. As early as 1998, Merrill had expressed reservations about Madoff and had flatly refused to invest its own funds or to recommend to its clients that they invest through BLMIS. C-¶¶ 718, 898. Although Merrill's concerns were communicated to the Sterling partners, again, no due diligence was performed and no attempt made to verify the allegations. C-¶¶ 904-912.

The warnings described above were not the first such warnings to the Sterling partners. From 1996 onward, other financial institutions and industry professionals with whom Sterling

communicated, as well as trade publication articles read by Sterling partners, had sounded the same alarm about Madoff, but all to no avail. See C-¶¶ 914-929, 932.

One option that the Sterling partners did consider in 2001 was the procurement of fraud insurance which Arthur Friedman, the Sterling partner responsible for opening, closing and monitoring the Defendants' BLMIS accounts, advised would expressly protect against, among other things, Ponzi scheme losses. Ultimately, the partners rejected the proposal because they believed the vast sums invested by them through BLMIS would be uninsurable. C-¶¶ 946-948.

Perhaps not surprisingly, therefore, instead of heeding the warnings about Madoff and investigating him, the Sterling partners took affirmative steps to protect him and to avoid drawing unnecessary attention to him and his operation, by regulators, and to the fact that BLMIS acted as an unregistered investment advisor. See C-¶¶ 949-973. The concealment went even further, when Sterling partners and Madoff became complicit in Madoff using BLMIS customer funds, to lend Sterling $54 million in order for it to finance the buy-out of the television network SNY. Instead of a loan by Madoff, the advance of funds was memorialized in a May 2004 letter as an "investment" by Ruth Madoff in SNY. C-¶¶ 990–1006. The letter was signed by Fred Wilpon, Saul Katz and Ruth Madoff. Wilpon and Katz clearly knew the representations in the letter of an "investment" to be false, and the transaction to be, in fact, an interest-free, no cost loan, from BLMIS to Sterling. C-¶ 1002.

The significance of the foregoing should have been all the compelling based on Sterling Stamos's experience with funds managed by the Bayou Superfund LLC, ultimately revealed to be a sizeable Ponzi scheme. Having been sued by the bankruptcy trustee in Bayou in 2006 and reached a multi-million settlement in 2009 for the partial return of principal and fictitious profit, the Sterling partners, who were investors in Sterling Stamos and assertedly in the Sterling

Stamos funds that invested in Bayou, should have recognized the telltale signs of the Madoff Ponzi scheme. C-¶¶ 1026 –1046. Instead, willingly seduced by the unrealistic returns generated in the BLMIS accounts and the special privileges afforded them, the Sterling partners affirmatively chose instead to exploit those advantages to the detriment of BLMIS customers. Their actions benefitted themselves and their fellow Defendant BLMIS accountholders as well as their subsequent transferees.

Having dramatically profited from the use of other investors' money while BLMIS operated, the Defendants would now benefit in its demise. Thus, certain of the Sterling Defendants and other Sterling-related entities filed 93 customer claims with the Trustee. See C-¶1326. While disclaiming liability, they seek to share in the spoils of the liquidation – namely, the SIPC advances and a share of customer property.

SUMMARY OF THE ARGUMENT

The issue raised by the Court concerns the content and scope, in an avoidance action brought in connection with a SIPA liquidation, of the fraudulent transfer defense made available through Section 548(c) of the Bankruptcy Code. That section exempts from the Bankruptcy Code's fraudulent transfer provision any transfer received by the transferee "for value and in good faith." See 11 U.S.C. § 548(c). For the reasons discussed below, unless Defendants can avail themselves of that defense, they are liable for the receipt of fraudulent transfers under Section 548(a)(1)(A) of the Bankruptcy Code (11 U.S.C.) and Section 276 of New York's Debtor and Creditor Law ("NYDCL"), inter alia, to the extent of roughly $1 billion.

Importantly, Section 548(c) creates an *affirmative defense*, facts relating to which need not be pled by the plaintiff in order to state a claim. As a result, issues relating to the availability of the defense cannot properly be resolved through a motion to dismiss.

In any event, application of the fraudulent transfer laws to creditors of a debtor in a SIPA liquidation – like most of the Defendants here – merely effects the readjustment of rights and obligations between and among estate creditors, an unequivocally Constitutional exercise and a fundamental goal in all bankruptcy proceedings. See SEC v. Albert & Maguire Sec. Co., 378 F.Supp. 906, 911-912 (E. D. Pa. 1974). The fact that some creditors may enjoy fewer property rights than they would have enjoyed outside of bankruptcy is neither exceptional nor unusual, and instead is part of the ordinary re-ordering and adjustment of creditor rights characteristic of bankruptcy.

Further, there is nothing in SIPA that modifies the "good faith" standard necessary to sustain the defense available under Section 548(c). On the contrary, SIPA incorporates that provision by reference, and includes a specific section (78fff-2(c)(3)) designed to ensure that Section 548, along with the other avoidance provisions of the Bankruptcy Code, apply to the fraudulent transfer of "customer property" to a customer of the liquidating broker-dealer.

Ultimately, the Defendants' potential liability here is not meaningfully different from what it was prior to the commencement of the BLMIS liquidation. At any time before that liquidation commenced, for example, the Defendants could have been sued under the NYDCL by other BLMIS investors, e.g., by investors who discovered the Ponzi scheme operated through BLMIS and lost money, on a net basis, through investment in the scheme. As in this case, the Defendants' avoidance of liability in such a suit would have depended upon their ability to sustain a defense under Section 278 of the NYDCL, which incorporates a "good faith" standard not meaningfully different than the one provided under Bankruptcy Code Section 548(c).

If the Defendants had attempted to use Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. §240.10b-5, to enforce their purported entitlement to the assets reflected

on the fictitious account statements they received from BLMIS - as they suggest they could have done – they would have faced essentially the same requirement. The statute of limitations on their claims would have begun to run when a reasonably diligent investor would have discovered the BLMIS fraud, and any claim brought after the expiration of the limitations period, as measured from that date, would have been time barred. Further, in order to sustain a claim under Rule 10b-5, the Defendants would have had to show that they reasonably relied upon the account statements that they received from BLMIS. To make that showing, they would have had to demonstrate that they did not ignore an obvious fraud without making a reasonable inquiry - effectively the same showing they now must make to demonstrate "good faith" under Section 548(c). That section thus imposes upon the Defendants no different duty than the one they had prior to the commencement of the BLMIS liquidation.

ARGUMENT

I. THE DEFENDANTS ARE LIABLE, INTER ALIA, UNDER SECTION 548(a)(1)(A) OF THE BANKRUPTCY CODE AND SECTION 276 OF THE NYDCL, UNLESS THEY CAN PROVE "GOOD FAITH"

Both Section 548(a)(1) of the Bankruptcy Code and Section 276 of the NYDCL provide for the avoidance of any transfer made with the "actual intent to hinder, delay or defraud" a creditor of the transferor. See 11 U.S.C. § 548(a)(1); NYDCL § 276. See also NYDCL §§ 278 and 279. Under both statutes, the intent of the transferor alone is relevant in determining the voidability of the transfer in question. In this context, the intent of the transferee in receiving the transfer does not matter. See, e.g., In re Bayou Group, LLC, 439 B.R. 284, 304 (S.D.N.Y. 2010) ("Bayou Group") ("Actual fraudulent conveyance claims under Section 548(a)(1)(A) turn on the intent of the debtor in making the transfer; the state of mind of the transferee is irrelevant"); In re Dreier LLP, 2011 WL 2412581, at ** 24, 28 (Bankr. S.D.N.Y. June 16, 2011) ("Dreier") ("[T]o

state a claim under NYDCL § 276 the Complaint need only sufficiently allege fraudulent intent by the transferor"). Further, in both cases, where actual intent to defraud on the part of the transferor is proven, the transfer will be set aside regardless of the quantum or adequacy of any consideration given by the transferee in exchange for the transfer. See, e.g., In re Sharp Int'l Corp., 403 F.3d 43, 56 (2d Cir. 2005) ("Sharp"); Bayou Group, 439 B.R. at 301, 304. Finally, a transfer that qualifies as an actual fraudulent conveyance under Section 548(a)(1)(A) and/or Section 276 may be avoided in its entirety, as to both invested principal and "profits." See, e.g., Sharp, 403 F.3d at 56; Bayou Group, 439 B.R. at 304.

To establish the intent required by Bankruptcy Code Section 548(a)(1)(A) and Section 276 of the NYDCL, it is not necessary to show that the transferor intended to target any particular entity or individual, merely that the transferor's intent was "directed toward present or future creditors." Bayou Group, 439 B.R. at 304. Moreover, in cases in which the debtor has operated a Ponzi scheme, actual fraudulent intent may be established as a matter of law with respect to transfers made in the course of the scheme, because such transfers "could have been made for no purpose other than to hinder delay or defraud creditors." Id. at 305 (quoting Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.), 359 B.R. 510, 517-18 (Bankr. S.D.N.Y.), aff'd, in part, and rev'd, in part, 397 B. R. 1 (S.D.N.Y. 2007)).

For the reasons discussed below, nothing in SIPA or federal securities law changes the application of these principles to a securities investor claiming the status of a "customer" in a SIPA liquidation. On the contrary, the courts in this jurisdiction have repeatedly applied these principles in that context to avoid fraudulent transfers made to investor/transferees. See, e.g., SEC v. S.J. Salmon & Co., 375 F. Supp. 867, 870-71 (S.D.N.Y. 1974) ("S.J. Salmon"); Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406, 435 (S.D.N.Y. 2001)

("Mishkin"); In re Stratton Oakmont, Inc., 239 B.R. 698, 701 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000) ("Stratton Oakmont"); In re Adler, Coleman Clearing Corp., 198 B.R. 70, 75 (Bankr. S.D.N.Y. 1996) ("Adler Coleman"). The Trustee has alleged – and it is not disputed - that BLMIS operated a Ponzi scheme and that the Defendants received the transfers in issue as part of the operation of that Ponzi scheme. The Defendants are liable under Section 548(a)(1)(A) of the Bankruptcy Code and Section 276 of the NYDCL, inter alia, for the receipt of actual fraudulent transfers unless they can sustain, among other elements, the good faith defense available under each of those statutes.

II. UNDER THE BANKRUPTCY CODE AND THE NYDCL, "GOOD FAITH" IS PART OF AN AFFIRMATIVE DEFENSE AND THUS SHOULD NOT BE DETERMINED ON A MOTION TO DISMISS

Once a plaintiff has made out a prima facie case for the avoidance of a transfer under the Bankruptcy Code or the NYDCL, the transferee may avoid rescission of the transfer by satisfying the terms of the defenses established through Bankruptcy Code Section 548(c) or Section 278(1) of the NYDCL, respectively. See, e.g., Bayou Group, 439 B.R. at 308; Dreier, 2011 WL 2412581, at ** 26, 32. As noted, "good faith" on the part of the transferee is an element of both defenses.[5] See, e.g., Bayou Group, 439 B.R. at 308-09; Dreier, 2011 WL 2412581, at ** 26, 42. In fact, the transferee bears the burden to establish its good faith as an *affirmative defense* that "may be raised and proved by the transferee at trial." Dreier, 2011 WL

[5] Section 278(1) of the NYDCL provides that a conveyance made to a transferee who gave "fair consideration" in exchange therefor, and who lacked "actual knowledge" of the fraud, is not avoidable under the statute. In order to show that it provided "fair consideration" for a challenged conveyance, the transferee must prove, inter alia, that it acted in "good faith" in exchanging the consideration provided for the property received. See NYDCL § 272. See also Sharp, 403 F.3d at 53-54; HBE Leasing Corp. v. Frank, 61 F.3d 1054, 1058-59 (2d Cir. 1995) ("HBE Leasing"); Dreier, 2011 WL 2412581, at *42.

2412581, at ** 26, 42 (quoting Picard v. Merkin (In re Bernard L. Madoff Investment Secs. LLC), 440 B.R. 243, 256 (Bankr. S.D.N.Y. 2010)). As a result, a plaintiff need not plead facts sufficient to demonstrate an absence of good faith in order to state a claim, and the question whether the transferee received the transfer at issue in good faith, when it arises as part of the affirmative defenses established through Bankruptcy Code Section 548(a)(1)(A) and NYDCL Section 278(a), should not be resolved on a motion to dismiss.[6] See, e.g., Dreier, 2011 WL 2412581 at 27 ("At the motion to dismiss stage, the Trustee need not plead lack of good faith as an element of the claim itself").

A. The Standards Governing "Good Faith" Under the Bankruptcy Code and the NYDCL Are Comparable

The "good faith" test applicable under Section 548(c) of the Bankruptcy Code consists of two inquiries. "The first question typically posed is whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose." Bayou Group, 439 B.R. at 310. Once it is clear that a transferee was on "inquiry notice" of either the transferor's possible insolvency or of the possibly fraudulent purpose of the transfer, the next question is whether the transferee conducted a diligent investigation of the facts that put it on inquiry notice. Id. at 312-13. As most commonly phrased, the question is whether diligent inquiry of these facts by the transferee would have revealed the fraudulent purpose of the transfer. Id.

[6] The Trustee also brings claims for constructive fraudulent conveyance under the NYDCL, however, which require proof that the transfer in question was made without "fair consideration" by the transferee in exchange for the transfer. See NYDCL §§ 273-75. The transferee must prove the consideration was given in "good faith" in order to meet the applicable standard for "fair consideration," and a plaintiff asserting claims for constructive fraudulent conveyance therefore must allege facts sufficient to establish the absence of "good faith" as part of the complaint. See NYDCL § 272; Dreier, 2011 WL 2412581, at *37-38.

An objective, "reasonable investor" standard applies to both components of Section 548(c)'s "good faith" test. Id. at 313. Under this standard, the focus is on what the transferee "knew or should have known," as an objective matter, rather than the transferee's actual knowledge and state of mind. Id. On several occasions, this Court has noted that, in applying this standard, the Court should not consider the perspective of a generic "reasonable investor," but rather that of an investor of the same class or category of investor as the transferee. See id.; In re Manhattan Inv. Fund Ltd., 397 B.R. 1, 23 (S.D.N.Y. 2007). Thus, for example, in one case, the Court applied the "inquiry notice" test from the point of view of a "reasonably prudent institutional hedge fund investor."[7] See Bayou Group, 439 B.R. at 313.

Under the NYDCL "good faith," a transferee with actual or constructive knowledge of the fraudulent scheme pursuant to which the challenged transfer was made is sufficient to vitiate good faith. HBE Leasing, 48 F.3d at 636; Dreier, 2011 WL 2412581, at * 43. In this regard, "constructive knowledge of fraudulent schemes will be attributed to transferees who were aware of circumstances that should have led them to inquire further into the circumstances of the transaction, but who failed to make such inquiry." HBE Leasing, 48 F.3d at 636. Cf., In re Refco Secs. Lit., 759 F.Supp.2d 301, 333 (S.D.N.Y. 2010) (Rakoff, J.). In practical application, this test is indistinguishable from Bankruptcy Code Section 548(c)'s "good faith" standard.

[7] Bankruptcy Code Section 550(a)(2) authorizes a bankruptcy trustee to recover property transferred by the initial transferee to a subsequent transferee. See 11 U.S.C. § 550(a)(2). Section 550(b)(1) provides an affirmative defense to such subsequent transferee comparable to the defense available to initial transferees under Section 548(c). See 11 U.S.C. § 550(b)(1). As in Section 548(c), the Section 550(b)(1) defense includes a "good faith" component, governed by a "good faith" standard identical to the one applicable under Section 548(c). See Dreier, 2011 WL 2412581, at * 44.

III. SIPA DOES NOT ALTER SECTION 548(c)'s "GOOD FAITH" STANDARD

Nothing in SIPA in any way alters the content or applicability of Section 548(c)'s "good faith" standard in a SIPA liquidation. On the contrary, as this Court and others in this jurisdiction have consistently recognized, SIPA and the rules promulgated thereunder "manifest a design to deny protection to transactions tainted by fraud." Mishkin, 263 B.R. at 435. See also Stratton Oakmont, 239 B.R. at 701; S.J. Salmon, 375 F. Supp. at 870-71; Adler Coleman, 198 B.R. at 75. Thus, for example, SIPA incorporates by reference the avoidance provisions of the Bankruptcy Code, to the extent consistent with SIPA, and the courts have long recognized that a SIPA liquidation is essentially a bankruptcy proceeding. See SIPA § 78fff(b). See also e.g., SIPC v. Ambassador Church Finance/Development Corp., 788 F.2d 1208, 1210 (6th Cir. 1986), cert. den. sub nom., Pine Street Baptist Church v. SIPC, 479 U.S. 850 (1986).

Further, to ensure that the Bankruptcy Code's avoidance provisions can be meaningfully applied in the special circumstances often present in liquidations under SIPA, Congress included a special provision in SIPA – Section 78fff-2(c)(3) - designed to ensure that the avoidance provisions apply to fraudulent transfers made to brokerage customers, and also apply regardless of the status of a customer as a "creditor" of the liquidating broker-dealer under state law. Specifically, Section 78fff-2(c)(3) provides generally that, for purposes of applying the avoidance powers under the Bankruptcy Code in a SIPA liquidation, customer property held by the debtor "shall be deemed to have been property of the debtor," and, if an avoidable transfer of such property was made to a customer, the transferee customer "shall be deemed to have been a

creditor [of the debtor], the laws of any State to the contrary notwithstanding."[8] See SIPA § 78fff-2(c)(3). As has long been noted, the purpose of this provision is to ensure that a SIPA trustee can use the avoidance powers conferred by the Bankruptcy Code to recover customer property, even though, prior to the commencement of the liquidation, such property was not "property of the debtor" and the debtor's brokerage customers were not its "creditors" under state fraudulent transfer law. See, e.g., Trefny v. Bear Stearns Secs. Corp., 243 B.R. 300, 321-322 (S.D. Tex. 1999); Hill v. Spencer Savings & Loan Assoc. (In re Bevill, Bresler & Schulman, Inc.), 83 B.R. 880, 894 (D.N.J. 1988). As one commentator has explained:

> A customer receiving a voidable transfer is deemed to be a creditor for purposes of avoidance, and the property so transferred is deemed to have been property of the debtor. The customer is not an actual creditor, and, under virtually all state and federal securities laws, the property does not belong to the debtor prior to transfer. The purpose of this legal fiction is to enable the trustee to fit the transfer into the provisions of the avoidance sections of the [Bankruptcy] Code. The legal fiction prevents a customer from using a technical reading of the avoidance provisions of the [Bankruptcy] Code to retain securities that would otherwise be recoverable by the trustee. The overall purpose of…15 U.S.C. § 78fff-2(c)(3) is to prevent one or more customers from depriving other customers of assets by keeping these assets out of the pool available for distribution to customers on a ratable basis.

---

[8] Section 78fff-2(c)(3) provides in full:

> Whenever customer property is not sufficient to pay in full the claims set forth in subparagraphs (A) through (D) of paragraph (1), the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of title 11. Such recovered property shall be treated as customer property. For purposes of such recovery, the property so transferred shall be deemed to have been the property of the debtor and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding.

6 Collier on Bankruptcy ¶ 749.02[1] at 749-4 (16th ed. 2011). See also Picard v. Taylor (In re Park South Securities, LLC, 326 B.R. 505, 512-13 (Bankr. S.D.N.Y. 2005) (SIPA trustee had standing to pursue avoidance actions against customers to whom debtor transferred funds from other customers' accounts); Hill v. Spencer Savings & Loan Assoc. (In re Bevill, Bresler & Schulman, Inc.), 94 B.R. 817, 825-26 (D.N.J. 1989) (granting summary judgment to SIPA trustee in action to avoid transfer of securities from debtor's common safekeeping account to customers' individual accounts at other institutions).

Consistent with Section 78fff-2(c)(3), the fraudulent transfer provisions of the Bankruptcy Code, and the companion provisions of applicable state law, have been repeatedly endorsed by the courts as a mechanism for the recovery of fraudulent transfers effected by a liquidating broker-dealer between customers of that broker-dealer. See, e.g., Mishkin, 263 B.R. at 435. See also Stratton Oakmont, 239 B.R. at 701; S.J. Salmon, 375 F. Supp. at 870-71; Adler Coleman, 198 B.R. at 75. Again, this application reflects an adaptation of one the fundamental functions of bankruptcy law – reordering debtor-creditor relations through the adjustment of priorities between and among creditors – to the unique circumstances that exist in liquidations under SIPA. See, e.g., In re Best Products, Inc., 68 F.3d 26, 31-32 (2d Cir. 1995) ("Fixing the order of priority of creditor claims against a debtor is an integral and historic bankruptcy function, and without this power the bankruptcy court would be rendered powerless to rehabilitate a debtor"); In re PSINet, Inc., 271 B.R. 1, 19 (Bankr. S.D.N.Y. 2001). In this regard, SIPC liquidations include a class of creditors not found in garden variety liquidation proceedings, namely, brokerage "customers" to whom the liquidating broker-dealer owes cash and/or securities. See SIPA § 78fff-2(c)(1); In re A.R. Baron Co., Inc., 226 B.R. 790, 794 (Bankr. S.D.N.Y. 1998). Accordingly, where the transferee from whom a SIPA trustee seeks to

recover property claims to be a "customer" of the debtor broker-dealer, and where the property that the trustee seeks to recover qualifies as "customer property" within the meaning of SIPA, the trustee's action merely helps ensure that "customer property" is distributed ratably, on the basis of customers' "net equities," as SIPA requires. See SIPA § 78fff-2(c)(1); In re Bernard L. Madoff Investment Secs. LLC, 424 B.R. 122, 132-34 (Bankr. S.D.N.Y. 2010), appeal pending, No. 10-2378 (2d Cir.).

This re-adjustment of rights between and among customer-creditors is a fundamental part of the bankruptcy process, and one entirely within the "bankruptcy power" conferred upon Congress through the Constitution. As this Court has explained:

> The United States Constitution confers broad powers upon Congress to establish "uniform laws on the subject of bankruptcies." Art. I, § 8, cl. 4. Pursuant to this expansive authority, Congress has consistently enacted bankruptcy statutes that have altered vested creditors' rights predating enactment.
>
> It is the essential nature of any bankruptcy legislation to modify and adjust debtor-creditor relationships, often affecting the vested rights of certain creditors to assure the equitable treatment of all creditors of the estate.

Drexel Burnham Lambert Group, Inc. v. Galdari, 1987 WL 6164 * 20 (S.D.N.Y. Jan. 29, 1987).

SIPC's rules, which are promulgated under the auspices of the SEC and have the force and effect of law, reinforce SIPA's emphasis on the importance of the avoidance provisions in the SIPA context. See, e.g., In re Adler, Coleman Clearing Corp., 218 B.R. 689, 699 (Bankr. S.D.N.Y. 1998) ("The SEC promulgated the SIPC rules…and they have the force and effect of law"). In this regard, SIPC Rule 503(a), 17 C.F.R. §300.503(a), precludes application of SIPC's Series 500 Rules, which, under some circumstances, determine the character of a customer's claim as one for cash or securities, if such application would interfere with a SIPA trustee's

ability to "avoid any securities transaction as fraudulent, preferential, or otherwise voidable under applicable law." See 17 C.F.R. § 300.503(a); Mishkin, 263 B.R. at 435 and n. 19.

The fact that, for some purposes, SIPA is to be treated as part of the Securities Exchange Act of 1934 ("1934 Act") has no effect on the character or content of the "good faith" standard applicable in avoidance actions brought in connection with liquidations under SIPA. While, under Section 78bbb of SIPA, liquidations under SIPA are to be treated, under some circumstances, as if SIPA "constituted an amendment to, and was included as a section of, such [1934] Act," this treatment is imposed only if SIPA does not provide otherwise. See SIPA § 78bbb ("Except as otherwise provided" in [SIPA,] the provisions of the [1934 Act] apply….") . As discussed, with regard to a SIPA trustee's avoidance powers, SIPA specifically incorporates by reference the Bankruptcy Code's avoidance provisions, and then adapts those provisions to the unique circumstances that obtain in liquidations under SIPA. See supra. In accordance with limiting language in Section 78bbb, the specificity of these provisions precludes the application of standards applicable under the 1934 Act, or any other provision of the federal securities laws, to the exercise of a trustee's avoidance powers.

IV. SECTION 548(c)'s "GOOD FAITH" STANDARD IS COMPARABLE TO FEDERAL AND STATE LAW STANDARDS APPLICABLE TO THE DEFENDANTS PRIOR TO THE BLMIS LIQUIDATION

In any event, there is no meaningful difference between Section 548(c)'s "good faith" standard and comparable standards under the federal securities laws. In fact, the Section 548(c) standard is nearly identical to standards to which the Defendants were already subject under both applicable state law, and the very federal securities law that the Defendants themselves invoke.

The Defendants point to SEC Rules 10b-10 and 10b-5 as the basis for their contention that they lacked any duty to investigate the information they had indicating that the payments

they received from BLMIS were made as part of the operation of a Ponzi scheme. (See Dkt. No. 2 at 11-14.) Rule 10b-10 requires a securities broker-dealer to provide a brokerage customer with a written confirmation of every transaction that occurs in the customer's account. See 17 C.F.R. § 240.10b-10. Like many of the securities laws, the rule is grounded in the notion that the securities markets function best through the disclosure of all material information. The rule is therefore designed to provide customers with information sufficient to enable them to properly exercise the substantive rights arising from their contractual relationships with their broker-dealers and *to detect fraudulent activity in their accounts*. See, e.g., Confirmation of Transactions, 59 Fed. Reg. 59,612, 59,613 (Nov. 17, 1994) ("For over 50 years, the customer confirmation has served basic investor protection *by conveying information* allowing investors to verify the terms of their transactions…*[and] acting as a safeguard against fraud*…" (emphasis added)). A premise underlying Rule 10b-10 is thus that investors will use the information contained on the confirmation statements provided to them pursuant to the rule to police activity in their accounts; not, as the Defendants suggest, to excuse them from any further duty of inquiry.

Rule 10b-5, upon which the Defendants also rely, makes the matter even clearer. The Defendants suggest that, through Rule 10b-5, "the federal [securities] laws enforce the customer's rights whether or not a broker actually purchased securities…" because a broker who accepts payment for securities that it never intends to deliver violates the rule.[9] (Dkt. No. 2 at 13.) But Rule 10b-5 imposes a duty to investigate upon an investor in at least two ways.

---

[9] The Defendants' reliance on Rule 10b-5 in this context is rather curious given that they could only have invoked the rule if they had discovered the BLMIS fraud. But the Defendants claim that they did not discover that fraud, and had no duty to do so. If so, Rule 10b-5 would have been of no use to them.

First, the statute of limitations governing actions brought under the Rule begins to run when a reasonably diligent investor would have discovered the fraud for which the plaintiff sues. See Merck & Co. v. Reynolds, __ U. S. __, 130 S.Ct. 1784, 1798 (2010); City of Pontiac Gen. Emps. Ret. Sys. v. MBIA, Inc., 637 F.3d 169, 174-75 (2d Cir. 2011) ("City of Pontiac"). The date a fact is deemed "discovered" is the date on which a reasonably diligent plaintiff could have pled that fact with sufficient detail and particularity to survive a motion to dismiss. See City of Pontiac, 637 F.3d at 175. An investor with information indicating that a securities transaction may be fraudulent, who elects not to conduct a diligent inquiry – or, as here, any inquiry at all - thus may be time-barred from bringing suit.

Second, an investor not time-barred from bringing suit must prove that he or she reasonably relied upon the fraudulent representations forming the basis for the suit, here, the cash and securities positions reflected in the fraudulent account statements supplied by BLMIS to the Defendants. See, e.g., First Lincoln Holdings, Inc. v. Equitable Life Assurance Society of U.S., 43 Fed.Appx. 462, 464 (2d Cir. 2002); Harsco Corp. v. Segui, 91 F.3d 337, 342 (2d Cir. 1997). Although the standard governing justifiable reliance in this context is most recently described in terms of "reasonably prudent investor," and at other times as "recklessness," the courts in this jurisdiction uniformly examine objective facts and circumstances in evaluating the reasonableness of an investor's purported reliance.[10] Compare, e.g., Crigger v. Fahnestock &

[10] Although they have never developed a list of all relevant factors, courts frequently consider, inter alia: (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence, or absence, or longstanding business or personal relationships between the plaintiff and the broker-dealer; (3) the extent to which the plaintiff had access to relevant information; (4) the existence, or absence, of a fiduciary relationship between the plaintiff and the broker-dealer; (5) the extent to which the broker-dealer concealed, or attempted to conceal, the fraud; (6) the extent to which the plaintiff had an opportunity to detect the fraud; (7) whether

Co., 443 F.3d 230, 234 (2d Cir. 2006), with Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc., 412 F.3d 103, 109 (2d Cir. 2005); Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1991) ("Brown"). As a result, although articulated slightly differently, this standard is functionally indistinguishable from the "reasonable investor" test applicable as part of Bankruptcy Code Section 548(c)'s "good faith" standard. Cf., Bayou Group, 439 B.R. at 313

The Defendants would have been no better off had they elected to proceed under state, rather than federal, law. Under New York law, a claim for common law fraud requires, inter alia, proof of reasonable reliance by the plaintiff upon material misrepresentations or omissions of fact by the defendant. See, e.g., Crigger, 443 F.3d at 234-35. In this context, the plaintiff has a duty to investigate the legitimacy of an investment opportunity where the plaintiff "was placed on guard or practically faced with the facts." Id. at 234. As under Bankruptcy Code Section 548(c), a plaintiff "cannot close his eyes to an obvious fraud, and cannot demonstrate reasonable reliance without making inquiry and investigation if he has the ability, through ordinary intelligence, to ferret out the truth about the reliability of an investment." Id. at 234-25. On this basis, the Second Circuit recently upheld the propriety of jury instructions which advised the jury that a plaintiff who invested in a Ponzi scheme had a duty to investigate the legitimacy of the investment. The court explained, inter alia, that:

> Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.

---

the plaintiff initiated or sought to expedite the transaction at issue; and (8) the generality or specificity of the misrepresentations in question. See Brown, 991 F.2d at 1032.

Id. at 235 (quoting Grumman Allied Indus., Inc. v. Rohr Indus., Inc., 748 F.2d 729, 737 (2d Cir. 1984)). See also First Capital Investment Holdings LLC v. Wilson Capital Group, Inc., 2011 WL 2119737, at *5 (S.D.N.Y. May 23, 2011) (Rakoff, J.) (denying summary judgment to plaintiffs based upon common law fraud claim brought under New York law because, inter alia, "[w]hile, with hindsight, it seems clear that plaintiffs were swindled, there is evidence from which a jury could conclude that their own alleged greed caused them to ignore what was plainly to be seen – thus implicating the issue of justifiable reliance"); Kosovich v. Metro Homes, LLC, 2009 WL 5171737, at *6 (S.D.N.Y. Dec. 30, 2009) (Rakoff, J.), aff'd, 405 Fed. Appx. 540 (2d Cir. 2010) (citing Fezzani v. Bear, Stearns & Co., 592 F.Supp.2d 410, 423 (S.D.N.Y. 2009) for the proposition that "[c]ourts in the Second Circuit have found that the elements of common law fraud are essentially the same as those which must be pleaded to establish a claim under § 10(b) and Rule 10b-5"). With the substitution of "good faith" for "justifiable reliance," the same reasoning applies with equal force under Bankruptcy Code Section 548(c).

Apart from the duty to investigate based on the Sterling Defendants' knowledge of the Madoff operation and their experience with Madoff, the Defendants could have been sued at any time under the actual fraud provision of Section 276 of the NYDCL by any other investor who discovered the BLMIS Ponzi scheme and lost money in it. Cf., Miller v. Harding, 2000 WL 1792990, at **1-2 (1st Cir. Dec. 5, 2000) (upholding summary judgment entered in favor of plaintiff in fraudulent conveyance suit brought by one Ponzi scheme investor against another under state fraudulent conveyance law). If that had occurred, the Defendants would have been liable under the NYDCL unless they could sustain a "good faith" defense under Section 278(1) – precisely the same situation in which they find themselves here. As noted, the "good faith" standard applicable under NYDCL Section 278(1) is no less rigorous than the one applicable

under Section 548(c), and the Defendants therefore are subject to no duty now that is different from any duty that they had pre-liquidation.[11] See supra.

Finally, it is worth noting that some of the Defendants were not BLMIS investors, at least with respect to the transfers in issue, but rather the subsequent transferees of such investors. These subsequent transferees therefore could have no claim to any special protection from the securities laws regarding the subject transfers, even assuming, for the sake of argument, such special protection were available to others.

[11] The Defendants suggest the fraudulent conveyance laws do not apply to transfers made to creditors of the transferor, and that they are immune from liability because the transfers to them discharged an antecedent debt. (See Dkt. No. 2 at 8-9.) The Defendants are mistaken on both points. Creditor status does not immunize the transferee of a fraudulent transfer from liability under the fraudulent conveyance laws, and the courts in this jurisdiction have regularly allowed fraudulent conveyance claims against creditors to go forward, particularly the recipients of Ponzi scheme payments. See, e.g., Dreier, 2011 WL 2412581, at ** 2-3 (denying motion to dismiss fraudulent conveyance claims brought under the NYDCL against "net winners" in Ponzi scheme). Moreover, for the reasons discussed in detail above, under the NYDCL, the fact that a payment discharges an antecedent debt is not relevant to the question whether the transferee has received an actual fraudulent conveyance within the meaning of NYDCL Section 276. See supra. It is relevant to the question whether the transferee gave "fair consideration" in exchange for the transferee under NYDCL Section 278(1). Even then however, the transferee must demonstrate that it received the transfer in question in "good faith" – the same obligation that the Defendants have here. See supra.

CONCLUSION

For all of the reasons stated in SIPC's main brief and in this supplemental brief, the Defendants' Motion should be denied.

Dated: July 22, 2011
Washington, D.C.

Respectfully submitted,

JOSEPHINE WANG
General Counsel

KEVIN H. BELL
Senior Associate General Counsel for Dispute Resolution

/s/ Christopher H. LaRosa
CHRISTOPHER H. LAROSA
Associate General Counsel

LAUREN T. ATTARD
Staff Attorney

SECURITIES INVESTOR
PROTECTION CORPORATION
805 15th Street, N.W.
Suite 800
Washington, D.C. 20005
Telephone: (202) 371-8300
E-mail: jwang@sipc.org
E-mail: kbell@sipc.org
E-mail: clarosa@sipc.org
E-mail: lattard@sipc.org