UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Debtor,	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
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. 10-5287 (BRL) 11-CV-03605 (JSR) (HBP)

TRUSTEE'S SUPPLEMENTAL MEMORANDUM OF LAW IN FURTHER OPPOSITION TO THE STERLING DEFENDANTS' MOTION TO DISMISS THE AMENDED COMPLAINT OR, IN THE ALTERNATIVE, FOR SUMMARY JUDGMENT

BAKER & HOSTETLER LLP
45 Rockefeller Plaza
New York, New York 10111
Telephone: (212) 589-4200
Facsimile: (212) 589-4201

Attorneys for Irving H. Picard, Trustee for the Substantively Consolidated SIPA Liquidation of Bernard L. Madoff Investment Securities LLC and Bernard L. Madoff

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DEFINITIONS

Amended Complaint (the "Complaint" or "Compl.")

Trustee's Memorandum in Opposition to the Sterling Defendants' Motion to Dismiss the Amended Complaint or, in the Alternative, for Summary Judgment (the "Trustee's Opposition" or "Tr.'s Br.")

Memorandum of Law in Support of the Sterling Defendants' Motion to Dismiss the Amended Complaint or, in the Alternative, for Summary Judgment (the "Motion to Dismiss" or "Defs.' Br.")

Memorandum of Law in Support of the Sterling Defendants' Motion to Withdraw the Reference (the "Motion to Withdraw" or "Defs.' Withdrawal Br.")

Additional Reforms to the Securities Investor Protection Act: Hearing Before The Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 111 Cong. 22 (Dec. 2009) (the "Cong. Subcomm. Hr'gs Dec. 2009")

By Order dated July 1, 2011, this Court withdrew the reference to the United States Bankruptcy Court in the above-captioned adversary proceeding to decide three threshold issues raised by the Sterling Defendants (the "Defendants") in their Motion to Dismiss the Amended Complaint or, in the Alternative, for Summary Judgment (the "Motion to Dismiss") previously filed before Bankruptcy Judge Lifland. Per this Court's July 1 Order, Irving H. Picard (the "Trustee"), as trustee for the substantively consolidated liquidation of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") and the estate of the Bernard L. Madoff ("Madoff") under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aa *et seq.*, by and through his undersigned counsel, respectfully submits the following Supplemental Memorandum in Further Opposition to the Motion to Dismiss.

PRELIMINARY STATEMENT

The Trustee's Complaint asserts fraudulent conveyance claims against the Defendants under the Bankruptcy Code (the "Code"), 11 U.S.C. §§ 101 *et. seq.*, and analogous provisions of McKinney's New York Debtor and Creditor Law ("NYDCL"), §§ 270 *et seq.*, and seeks to avoid and recover approximately $300 million in fictitious profits that the Defendants received over the course of the Ponzi scheme. The Trustee also seeks approximately $700 million in transfers representing the return of principal investment that the Defendants received within the *six-year period* prior to December 11, 2008, a time when they were on inquiry notice of the fraud. Under well-established principles of fraudulent conveyance laws, the Defendants cannot retain these fraudulent transfers because at the time they received them, the Defendants lacked "good faith."

On July 1, 2011, this Court withdrew the reference "to make a determination of the threshold issues that were raised by the movants," which "include[d] all three issues raised by movants" in their Motion to Withdraw: (i) whether, in connection with the Defendants' affirmative defense of good faith to the Trustee's fraudulent conveyance claims, SIPA (which

incorporates the Code) and the NYDCL improperly impose a retroactive duty of inquiry on the Defendants that they did not previously have under federal securities laws; (ii) whether the Defendants were owed an antecedent debt by BLMIS as set forth on their customer statements that would preclude the Trustee's fraudulent conveyance claims; and (iii) whether § 546(e) of the Code provides a "safe harbor" for the fraudulent transfers made by BLMIS to the Defendants. (Dkt. No. 33, Tr. 32-34.)

The standard applicable to the Defendants' affirmative defense of good faith to the Trustee's fraudulent conveyance claims is the objective "reasonably prudent" transferee test set forth in the jurisprudence under the Code and the NYDCL. Attempting to exempt themselves from the fraudulent conveyance laws and their obligation to demonstrate good faith to retain the fraudulent transfers they received from Madoff, the Defendants argue that the Code and the NYDCL impermissibly impose upon them a retroactive duty of due diligence that they did not otherwise have under the securities laws. (Defs.' Withdrawal Br. 23.) To the contrary, the fraudulent conveyance laws impose no duty of inquiry the Defendants did not already have under the federal securities laws or the New York common law. Where investors, like the Defendants here, admittedly failed to conduct an inquiry and were "willfully blind"[1] to facts that call for investigation, notice of the fraud is imputed to them—under the fraudulent conveyance laws, the federal securities laws, and the New York common law.

The other arguments advanced by the Defendants in their pursuit to immunize themselves

[1] As used in the Complaint and herein, the terms "willful blindness," "closed eyes," "conscious disregard" or "conscious avoidance" refer to the Defendants' conduct, not the legal standard governing their good faith. As discussed below, whether or not the Defendants can establish their affirmative defense of good faith under the Code or the NYDCL turns on whether they were on notice of facts that would have caused a reasonable person to inquire into the legitimacy of their investments with Madoff. Defendants' willful blindness to Madoff's fraud is evidence that they cannot meet that burden.

from the Trustee's avoidance claims are similarly without merit. The Defendants were not owed an antecedent debt on account of their last fictitious BLMIS statements, and § 546(e) of the Code does not provide a "safe harbor" to transfers Madoff made to the Defendants in furtherance of the Ponzi scheme.

I. THE CODE AND THE NYDCL GOVERN THE QUESTION OF THE DEFENDANTS' GOOD FAITH AND DUTY OF INQUIRY

The current action is part of a SIPA proceeding that is conducted in accordance with chapters 1, 3, 5, 7 and Parts I and II of title 11 of the United States Code. SIPA § 78fff-2(c)(3) explicitly authorizes the Trustee to avoid and recover transfers that are void or voidable under the Code, including transfers "to or on behalf of" customers, such as the Defendants. Notably, this provision of SIPA refers only to the Code in connection with the avoidance and recovery of fraudulent and preferential transfers, and makes no reference to any other federal regulatory schemes, including the federal securities laws.

Thus, the issue of good faith, which is an affirmative defense to the Trustee's fraudulent conveyance claims, is governed by the Code, the NYDCL,[2] and the applicable case law thereunder, which establishes the parameters of the "duty of inquiry" in connection with the transfers Defendants received from BLMIS.[3] While the Code contains some express "safe

[2] Pursuant to § 544(b) of the Code, the Trustee may also avoid any transfer that is avoidable under relevant state law—in this case, NYDCL §§ 273-76.

[3] Neither the Code nor the NYDCL requires the Trustee to plead transferee intent to defraud in order to avoid fraudulent transfers. *See Gowan v. The Patriot Grp. (In re Dreier),* 2011 WL 2412581, at *24, *28-33 (Bankr. S.D.N.Y. June 16, 2011). Without any basis in law, the Defendants seek to transform their own burden of proving a good faith defense, which implicates their duty of inquiry once on notice, into an additional element that the Trustee must prove. They argue that the Trustee must prove the element of actual knowledge often seen in aiding or abetting fraud cases under the securities laws, because they were customers of a SIPA registered entity and had no duty "to question their broker's statements." (Defs.' Br. at 68-69.) The Defendants' arguments would necessitate rewriting SIPA to incorporate the securities laws instead of the Code, or rewriting the Code and the NYDCL to impose both a heightened pleading

harbors" that exempt particular categories of transfer recipients and/or particular types of transfers from the avoidance provisions, transfers to broker-dealer "customers" in furtherance of a Ponzi scheme are not among them. *See* 11 U.S.C. § 546.

A. Good Faith Under The Code Requires A Reasonable Inquiry In The Face Of Possible Fraud

The good faith defense under § 548(c) involves a two-step inquiry: "(1) whether [the transferee] was on inquiry notice of the [debtor's] fraud and (2) whether the [transferee] was diligent in its investigation of the [debtor]." *Bear, Stearns Secs. Corp. v. Gredd* (*In re Manhattan Inv. Fund Ltd.*) ("*Manhattan II*"), 397 B.R. 1, 23 (S.D.N.Y. 2007), *aff'd*, 2009 U.S. App. LEXIS 11806 (2d Cir. June 2, 2009); *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC* (*In re Bayou Group, LLC*) *("Bayou"),* 439 B.R. 284, 310-12 (S.D.N.Y. 2010); (Tr.'s Br. 80-81.) "An objective, reasonable investor standard applies to both the inquiry notice and the diligent investigation components of the good faith test." *Bayou*, 439 B.R. at 313 (collecting cases). This analysis focuses on whether the Defendants had information that would have suggested to a reasonably prudent investor that he should have investigated further, and then determines whether the investigation was reasonable under the circumstances. *Manhattan II*, 397 B.R. at 23; *Bayou*, 439 B.R. at 310-13.

"Inquiry notice is informed by the standards, norms, practices, sophistication and experience generally possessed by" investors similar to the Defendants. *Bayou,* 439 B.R. at 313. Once on inquiry notice, unless a defendant conducts a diligent investigation, it cannot carry its burden of establishing good faith. *Manhattan II*, 397 B.R. at 22-23; *see also Gredd v. Bear,*

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standard and an additional element of intent that is not found in either statutory scheme. That said, to the extent it were required, the Complaint meets even a knowledge-based standard because it alleges with specificity that the Defendants ignored all reasonably diligent inquiries into any of the indicia of fraud known to them. (*See generally* Compl. Sects. IX-X.)

Stearns Secs. Corp. (*In re Manhattan Inv. Fund Ltd.*) ("*Manhattan I*"), 359 B.R. 510, 526 (Bankr. S.D.N.Y. 2007) (diligent investigation requires "more than simply ask[ing] the wrongdoer if he was doing wrong"); *Roeder v. Lockwood and First Nat. Bank (In re Lockwood Auto Grp., Inc.)*, 428 B.R. 629, 636 (Bankr. W.D. Pa. 2010). A transferee on inquiry notice cannot turn a blind eye to mounting evidence of fraud, and if he chooses not to inquire, he will be found to lack good faith. *Manhattan II*, 397 B.R. at 25 n.39 ("[g]iven what [Defendants] learned, taking no steps at all. . . amounted to willful ignorance, which . . . defeat[s] the good faith defense."); *Armstrong v. Collins*, 2010 U.S. Dist. LEXIS 28075, at *82-83 (S.D.N.Y. Mar. 24, 2010); *In re Gosman*, 2005 Bankr. LEXIS 3183, at *52 (Bankr. S.D. Fla. Mar. 1, 2005); *Cuthill v. Greenmark, LLC (In re World Vision Entm't, Inc.)*, 275 B.R. 641, 599 (Bankr. M.D. Fl. 2002); (Tr.'s Br. 82.).[4]

This district,[5] and all of the circuits that have addressed this issue have applied an

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[4] Congress has considered and rejected proposals that would have amended SIPA to elevate the objective "reasonably prudent" standard to a heightened standard when examining a transferee's good faith defense. In December 2009, Professor John C. Coffee, Jr., Professor of Law at Columbia University Law School, testified before a House of Representatives subcommittee regarding that proposed amendment:

> Today, anyone who is sued in a fraudulent conveyance has a good faith defense under the Bankruptcy Code. The case law has construed that to mean that you have to show not just subjective good faith, but that you have the good faith of an objective reasonable person. It's a negligence test.

Cong. Subcomm. Hr'gs Dec. 2009, at 22. This bill has not been enacted.

[5] This Court recently recognized that "[c]onstructive knowledge is '[k]nowledge that one using reasonable care or diligence should have, and therefore that is attributed by law to a given person.'" *Kirschner v. Bennett (In re Refco Secs. Litig.)*, 759 F. Supp. 2d 301, 334 (S.D.N.Y. 2010) (quoting *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC*, 479 F. Supp. 2d 349, 368 (S.D.N.Y. 2009)). Constructive knowledge is consistent with long-standing hornbook principles of equity. Pomeroy & Symons, A Treatise on Equity Jurisprudence as Administered in the United States of America § 606 (5th Ed. 1941) ("Constructive knowledge as generally applied by the American courts has been to inquire whether the facts are sufficient to put a prudent man upon an inquiry, and whether an inquiry has been prosecuted with reasonable care and diligence."); *see also In re Dreier*, 2011 WL 2412581, at *42-47 (Bankr. S.D.N.Y. 2011)

objective standard in determining a transferee's good faith under the Code.[6] This standard is consistently applied in actions seeking the return of principal from Ponzi scheme investors.[7] The objective, "reasonably prudent" standard for inquiry notice and diligent investigation is not of recent vintage in the fraudulent conveyance laws. For example, in *Schauer v. Alterton*, 151 U.S. 607, 621 (1894), Justice Harlan wrote for the Supreme Court:

> [I]f [the transferee] had knowledge or actual notice of circumstances sufficient to put him, as a prudent man, upon inquiry as to whether his brother intended to delay or defraud his creditors, and he omitted to make such inquiry with reasonable diligence, he should have been deemed to have notice of such fact, and therefore such notice as would invalidate the sale to him, if such sale was in fact made with the intent upon the part of the vendor to delay or defraud other creditors.

B. Good Faith Under The NYDCL Also Involves An Objective Duty Of Inquiry

Because the fraudulent conveyance provisions of the NYDCL and the Code are applied in parallel,[8] the test for good faith under the NYDCL is equivalent to that under § 548(c) of the Code. Pursuant to the NYDCL, "*[c]onstructive 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*

(observing without deciding proper legal standard for good faith affirmative defense that "most courts have applied an 'objective' or 'reasonable person' standard to a transferee's 'good faith' defense under § 548(c)") (citations omitted).

[6] *Bayou*, 439 B.R. at 310 n.23 (collecting cases applying objective good faith under § 548(c)); *Manhattan II,* 397 B.R. at 22-23; *Brown v. Third Nat'l Bank* (*In re Sherman*), 67 F.3d 1348, 1355 (8th Cir. 1995); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Grp.),* 916 F.2d 528, 535-36 (9th Cir. 1990); *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1334-38 (10th Cir. 1996).

[7] *See Bayou*, 439 B.R. at 313-14; *Armstrong*, 2010 U.S. Dist. LEXIS 28075, at *59-60; *SEC v. Forte*, 2009 WL 4809804, at *6 (E.D. Pa. Dec. 15, 2009); *Terry v. June*, 432 F. Supp. 2d 635, 641 (W.D. Va. 2006); *Fisher v. Sellis (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 878 (Bankr. N.D. Ill. 2000).

[8] *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 116 (Bankr. S.D.N.Y. 1999) ("The two statutes devolve from the same source, are founded on the same principles and are designed to effectuate the same purposes.").

Leasing Corp. v. Frank, 48 F.3d 623, 636 (2d Cir. 1995) (emphasis added). Good faith under the NYDCL also involves an objective, "reasonable" inquiry and a transferee's failure to reasonably inquire into suspicious circumstances defeats a defendant's good faith defense.[9]

C. The Defendants Were Willfully Blind To Facts That Would Have Caused A Reasonably Prudent Person To Investigate Possible Fraud

The Trustee alleges that the Defendants knew of facts that would have placed a reasonably prudent person in their position on inquiry notice concerning the legitimacy of their BLMIS investments. Their deliberate and admitted failure to investigate, and their continued willful blindness to suspicious facts that demanded investigation, defeat any notion that the Defendants received transfers from BLMIS in good faith.[10]

The Sterling Partners (as defined in the Complaint) were long-time close friends and business partners of Madoff, who substantially benefitted from the Ponzi scheme. (Compl. ¶¶ 732-41.) In addition to the hundreds of millions in fictitious profits they received, Madoff allowed Defendants to use their accounts as collateral to borrow funds that were reinvested with BLMIS (enabling them to double their returns) and as leverage to obtain significant sources of financing for their multitude of businesses. (*Id.* ¶¶ 782-90.) The Defendants' collective finances and financing ability for every aspect of their business became so dependent upon their BLMIS accounts that they could not extract their investments from Madoff without near financial collapse, as demonstrated by events post-revelation of the fraud. (*Id.* ¶¶ 853-64.)

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[9] *See United States v. Orozco-Prada*, 636 F. Supp. 1537, 1543 (S.D.N.Y. 1986), *aff'd*, 847 F.2d 836 (2d Cir. 1988); *Interpool Ltd. v. Patterson*, 890 F. Supp. 259, 268 (S.D.N.Y. 1995); (Tr.'s Br. 87-88.).

[10] *See In re Dreier*, 2011 WL 24122581, at *46 (in discussing generally the principles of "conscious turning away," "conscious avoidance," "conscious ignorance" and an "ostrich defense" "most often applied in criminal cases," the court noted that "if it is proved that the [d]efendants consciously avoided facts that would suggest that the transfers were made with a lack of good faith, the [d]efendants may not retain the otherwise avoidable transfers based on the § 548(c) defense") (citations omitted).

The Sterling Partners are sophisticated investors collectively worth several hundreds of millions of dollars, if not more, who own a business enterprise that includes, among other things, a real estate empire and a baseball franchise. (*Id.* ¶¶ 656-72.) They partnered with investment professionals to form their own hedge fund, Sterling Stamos, of which they currently remain general partners. (*Id.* ¶¶ 702-10, 879-80, 1067-71.) And unlike any other retail BLMIS customer, the Sterling Partners opened and administered 483 BLMIS accounts: approximately 300 for themselves, their families, trusts and entities; the rest for friends, employees, and business associates they brought to BLMIS. (*Id.* ¶¶ 678-79.)

During the six years prior to Madoff's confession, the Defendants continued to invest hundreds of millions with Madoff despite mounting evidence strongly suggesting the potentially fraudulent nature of their BLMIS investments, including:

- The Sterling Partners knew of industry articles published in early 2001 in which many hedge fund industry professionals questioned Madoff's legitimacy and reported returns (Compl. ¶¶ 925-32; Tr.'s Br. Sect. I.A.);
- The Sterling Partners investigated obtaining a "one-of-a-kind" insurance policy to protect their Madoff investments against fraud, including coverage expressly for a Ponzi scheme (Compl. ¶¶ 938-48; Tr.'s Br. Sect. I.A.);
- The Sterling Partners were repeatedly told by their hedge fund partners at Sterling Stamos that BLMIS would fail its due diligence protocols and that as fiduciaries, Sterling Stamos could not invest any of its own investors' funds with BLMIS (Compl. ¶¶ 867-937; Tr.'s Br. Sects. I.E, 1.F.);
- The Sterling Partners formed Sterling Stamos for the express purpose of recreating Madoff-like returns, but it could not duplicate Madoff's returns (Compl. ¶¶ 1067-71), and Defendant Saul Katz admitted that "nobody knows how Madoff does it" (Compl. ¶ 1050.);
- The Sterling Partners discussed with Sterling Stamos the potential that Madoff might be engaging in illegal front-running at BLMIS, including that their hundreds of millions of dollars invested with Madoff could be frozen if BLMIS were even investigated (Compl. ¶¶ 881, 886-90, 902; Tr.'s Br. Sects. I.E.2, I.F.1.);
- The Sterling Partners were warned on repeated occasions by their Sterling Stamos hedge fund partners—who openly questioned Madoff's legitimacy for years—that they should redeem their investments from BLMIS (Compl. ¶¶ 868-74.);

- A Merrill Lynch executive expressly warned the Sterling Partners of his serious concerns about Madoff's legitimacy. The Merrill executive rejected Defendant Saul Katz' suggestion that Sterling Stamos invest with BLMIS, advising him that Madoff would not pass Merrill's due diligence requirements (*id.* ¶¶ 897-912.);
- Other industry professionals warned the Sterling Partners of their concerns regarding Madoff's legitimacy (*id.* ¶¶ 913-19.);
- The Sterling Partners appeased Madoff's demands for secrecy and avoidance of regulatory scrutiny by restructuring Sterling Stamos at great expense and effort in order to avoid having to make any disclosures (*id.* ¶¶ 949-67; Tr.'s Br. Sect. I.D.);
- The Sterling Partners were familiar with the SEC's registration and disclosure rules for investment advisers and should have known that Madoff was evading his obligation to register (Compl. ¶¶ 968-73.);
- From the Sterling Partners' experience in another Ponzi scheme, Bayou Superfund LLC ("Bayou"), they knew that many of the same "red flags" that led to their redemption out of Bayou were also present with regard to their BLMIS investments (*id.* ¶¶ 891-94; 1025-46; Tr.'s Br. Sect. I.G.);
- The Sterling Partners failed to conduct any diligence into a "special" investment opportunity Madoff offered them, which involved a different strategy, i.e., "style drift," he promised would generate *returns of up to 50% more than usual*, but for which required *new* capital. Without conducting any due diligence in connection with this new "strategy," indeed without even an understanding as to what the new strategy entailed, the Sterling Partners blindly invested another $22 million with Madoff (Compl. ¶¶ 1041-45; Tr.'s Br. 34-35.); and
- Certain Sterling Partners knew that Madoff was willing to falsify significant business transactions because Defendants Fred Wilpon, Saul Katz and Marvin Tepper worked together with Madoff to falsely document a $54 million transaction (Compl. ¶¶ 990-1006; Tr.'s Br. Sect. I.J.).

When faced with a mountain of red flags, express warnings from trusted, professional financial advisors, and their own suspicions that their investment returns might be the product of fraudulent and even criminal activity (including, in particular, a Ponzi scheme), rather than doing what reasonably prudent and notably *sophisticated* investors with hundreds of millions of dollars at stake would do—redeem, as they were urged to do by their trusted advisors, or conduct some modicum of diligence to protect their investments—the Sterling Defendants did neither. Instead, the Partner Defendants continued to invest hundreds of millions of dollars with Madoff, choosing instead to avoid confirming the obvious, and admittedly conducted no diligence or investigation

into any of the indicia of fraud surrounding their BLMIS investments. (*See* Compl. ¶¶ 12, 890, 895, 905, 912, 914, 932, 1024, 1045-46, 1057, 1061, 1064, 1074-75; Tr.'s Br. 33-35.)

The Sterling Defendants' willful blindness to the mounting facts which suggested that their BLMIS investment returns might be the product of illegal or fraudulent activity fails as a matter of law to satisfy the "good faith" defense.

D. The Defendants' Good Faith Is An Affirmative Defense And Issue Of Fact

Under both the Code and NYDCL § 276,[11] proving good faith is the Defendants' burden as an affirmative defense that need not be pled in the Complaint[12] and is a question of fact. Courts routinely deny motions to dismiss fraudulent conveyance claims on the ground that a defendant's good faith cannot be resolved until full discovery of the evidentiary record.[13]

II. THE FEDERAL SECURITIES LAWS AND NEW YORK COMMON LAW RECOGNIZE THAT INVESTORS HAVE A DUTY OF INQUIRY IN CONNECTION WITH THEIR INVESTMENTS

Contrary to the Defendants' argument, the fraudulent conveyance laws did not impose

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[11] Although good faith is an element of the Trustee's *prima facie* constructive fraud claims under §§ 273-75 (Tr.'s Br. 78-79), these claims are not subject to the heightened pleading standard of Fed. R. Civ. P. 9(b) as "[t]his is not the kind of fraud to which Rule 9(b) applies." *Eclaire Advisor Ltd. v. Daewoo Eng.*, 375 F. Supp. 2d 257, 268 (S.D.N.Y. 2005) (Rakoff, J.). Rather, all that is required is that the Trustee's claims meet the "bare-bones pleading requirements of Rule 8, Fed. R. Civ. P.," *id.*, which the Trustee has undoubtedly gone beyond.

[12] *In re Dreier*, 2011 WL 2412581, at *26 (good faith under Code § 548(c) is not an element of trustee's *prima facie* case, and that transferees bear the burden of establishing good faith as to both actual and constructive fraud claims; further holding same as to intentional fraud under NYDCL § 276); *SIPC v. Stratton Oakmont, Inc.*, 234 B.R. 293, 318 (Bankr. S.D.N.Y. 1999); *Bayou*, 439 B.R. at 303-308; *Manhattan II*, 397 B.R. at 22; (Tr.'s Br. 72-74.).

[13] *In re Dreier*, 2011 WL 2412581, at *26-*29, *33 (declining to consider Code § 548(c) defense on a motion to dismiss, noting that "good faith" under § 548(c) is appropriately addressed at summary judgment after discovery or trial); *Manhattan II*, 397 B.R. at 23 (denying motion for summary judgment on good faith); *Eclaire Advisor Ltd.*, 375 F. Supp. 2d at 269 n.5 ("[T]he question of whether a transfer is made for fair consideration is a question of fact most suitably resolved at the summary judgment stage."); *SIPC v. Rossi (In re Cambridge Capital, LLC)*, 331 B.R. 47, 63-64 (Bankr. E.D.N.Y. 2005) (same); (Tr.'s Br. 70-71.).

upon the Defendants a duty of inquiry they did not already have under the federal securities laws or the New York common law, both of which impose upon investors a duty to inquire when alerted to suspicious circumstances indicating potential fraud in connection with their investments. Because the Defendants deliberately failed to make a reasonable inquiry and chose to close their eyes to the circumstances that called for investigation, the securities laws and the common law impute knowledge of Madoff's fraud to them.

A. The Federal Securities Laws And New York Common Law Impose A Duty Upon Investors To Inquire When On Notice of Possible Fraud

It is well-settled under the securities laws and New York common law that "[w]here the circumstances would suggest to an investor of ordinary intelligence the probability that it has been defrauded, a duty of inquiry arises, and knowledge will be imputed to the investor who does not make such an inquiry."[14] *Steed Finance LDC v. Nomura Secs. Int'l, Inc.*, No. 00 Civ. 8058, 2004 U.S. Dist. LEXIS 18580, *23-24 (S.D.N.Y. Sept. 14, 2004), *aff'd*, 148 Fed. App'x 66 (2d Cir. 2005); *accord Thomas H. Lee Equity Fund V, LP v. Grant Thornton LLP* (*In re Refco Secs. Litig.*), No. 07 MDL 1092 (JSR), 07 Civ. 8663 (JSR), 2011 U.S. Dist. LEXIS 33554, at *45 (S.D.N.Y. Mar. 28, 2011) ("When a party is aware of circumstances that indicate certain representations may be false, that party cannot reasonably rely on those representations, but must make additional inquiry to determine their accuracy."); *Barron Partners LP v. Lab123, Inc.*, No. 07 Civ. 11135 (JSR), 2008 WL 2902187, at *5 n.3 (S.D.N.Y. July 25, 2008) (in context of securities fraud claims, this Court noting that "[r]easonable reliance entails a duty to investigate

[14] *See Domenikos v. Roth*, 288 Fed. App'x 718, 719-720 (2d Cir. 2008) (knowledge of fraud imputed to plaintiff who, like the Defendants here, performed no inquiry whatsoever) (citations omitted); *Staehr v. Hartford Fin. Servs. Grp., Inc.*, 547 F.3d 406, 427 (2d Cir. 2008) ("Storm warnings need not detail every aspect of the alleged fraudulent scheme.") (citation and marks omitted)); *In re Polaroid Corp. Secs. Litig.*, 465 F. Supp. 2d 232, 243 n.2 (S.D.N.Y. 2006) ("[C]oncept of inquiry notice is hostile to the notion [of] 'leisurely discovery'" of the scheme) (citations omitted).

the legitimacy of an investment opportunity where plaintiff was placed on guard or practically faced with the facts" (citation omitted)); *In re Eugenia VI Venture Holdings, Ltd. Litig.*, 649 F.Supp.2d 105, 118 (S.D.N.Y. 2008) (a heightened degree of diligence is required of an investor where circumstances were such that the investor "had hints of falsity") (citation omitted)).

In the common law fraud context, the Second Circuit in *Crigger v. Fahnestock & Co.*, 443 F.3d 230 (2d Cir. 2006), articulated the reasonably prudent investor duty of inquiry as follows:

> Circumstances may be so suspicious as to suggest to a reasonably prudent plaintiff that the defendants' representations may be false, and that the plaintiff cannot reasonably rely on those representations, but rather must make additional inquiry to determine their accuracy. Put another way, if the plaintiff has the means of knowing, by the exercise of ordinary intelligence, the truth, or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.

Id. at 234-35 (citations and marks omitted).

Likewise, the New York Court of Appeals has long recognized the duty of inquiry under New York common law for claims sounding in fraud:

> [W]here the circumstances are such as to suggest to a person of ordinary intelligence the probability that he has been defrauded, a duty of inquiry arises, and if he omits that inquiry when it would have developed the truth, and shuts his eyes to the facts which call for investigation, *knowledge of the fraud will be imputed to him.*

Higgins v. Crouse, 147 N.Y. 411, 416, 42 N.E. 6, 11-12 (1895) (emphasis added).[15] "While the law does not require that a defrauded party go to the ends of the earth to discover the falsity of a statement, patent foolishness is not excused." *First Capital Inv. Holdings LLC v. Wilson Capital Group, Inc.*, No. 10 Civ. 2948 (JSR), 2011 U.S. Dist. LEXIS 57638, at *15-16 (S.D.N.Y. May

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[15] *Accord In re Global Crossing Ltd. Secs. Litig.*, 313 F.Supp.2d 189, 202 (2d Cir. 2003) ("Inquiry notice is tantamount to actual discovery of a fraud when a plaintiff, having received knowledge sufficient to trigger a diligent investigation, fails to inquire into the facts.").

23, 2011) (emphasizing how investors "appear not to have conducted the *slightest due diligence*, for example, they made no effort" to verify information material and relevant to their investment (citations omitted) (emphasis added)).[16]

1. An Investor's Duty of Inquiry Is Evaluated Under An Objective Standard

The securities laws and common law analyze an investor's duty of inquiry applying an *objective* test. *See Armstrong v. McAlpin*, 699 F.2d 79, 86-88 (2d Cir. 1983); *see also Wood v. Carpenter*, 101 U.S. 135, 141 (1879) ("The presumption is that if the party affected by any fraudulent transaction or management might, with ordinary care and attention, have reasonably detected it, he reasonably had actual knowledge of it."); *Dodds v. Cigna Secs., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993) (in securities fraud context, inquiry notice standard is objective); *Crigger*, 443 F.3d at 236 ("[T]here was ample evidence that the . . . investment opportunity was a Ponzi scheme and that investors of *reasonable means and prudence* . . . bore a legal duty at least to inquire further . . . ." (emphasis added)). Defendants here fail that test.

2. Sophisticated Investors Have A Heightened Degree Of Diligence

"[T]he more sophisticated the investor and the more resources available to the investor, the greater the burden on the investor to act to protect itself." *Steed Finance LDC*, 2004 U.S.

[16] The Defendants claim that as a result of *Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1797 (2010), inquiry notice is "plainly not the applicable standard" for the Trustee's claims. (Defs.' Br. 69 n.30.) *Merck* stands for no such thing. *Merck* arises in the context of when the statute of limitations has run for claims under the Securities Exchange Act of 1934 § 10(b), "based on the precise language of that statute." *In re IndyMac Mortg.-Backed Secs. Litig.*, No. 09 Civ. 4583 (LAK), 2011 U.S. Dist. LEXIS 67781, at *26 (S.D.N.Y. June 21, 2011). Far from "reject[ing] inquiry notice . . . the Supreme Court explicitly reaffirmed the doctrine," noting its application to "not only those facts that plaintiff actually knew" but that a hypothetical, reasonably diligent plaintiff could have known. *Cohen v. Cohen*, No. 09 Civ. 10230 (RJH), 2010 WL 1157283, at *18 (S.D.N.Y. March 29, 2011). Here, the Trustee's fraudulent conveyance claims brought under the Code and NYDCL implicate neither the heightened pleading standards of scienter for a plaintiff suing for fraud under the Securities Exchange Act nor the statute of limitations for any claim.

Dist. LEXIS 18580, at *23 (citation omitted). While the "law is indulgent of the simple or untutored; . . . the greater the sophistication of the investor, the more inquiry that is required." *Crigger*, 443 F.3d at 235.

The Defendants here are not "widows or orphans," *Schlaifer Nance & Co. v. Estate of Warhol*, 119 F.3d 91, 98 (2d Cir. 1997), but rather, are extremely sophisticated businessmen and investors. "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." *Id.* (quoting *Grumman Allied Indus. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 (2d Cir. 1984)); *see also In re Refco Secs. Litig.*, 2011 U.S. Dist. LEXIS 33554, at *44-45 (this Court noted that the standards for an investor's duty to inquire are "understandably more exacting" when the investor is a "sophisticated business entity").[17]

B. Because Of Their Willful Blindness To Facts That Should Have Prompted An Investigation, The Defendants Are Deemed To Be On Notice Of The Fraud Under The Securities Laws And New York Common Law

The application of analogous federal securities and common law principles to the

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[17] The Second Circuit has articulated "reasonable reliance" so as to meet the elements of a fraud claim in terms of a "reasonably prudent" investor. *See Crigger v. Fahnestock and Co., Inc.*, 443 F.3d 230, 234 (2d Cir. 2006) (concluding that reasonable and prudent investors had a duty to investigate the legitimacy of their investment opportunity in the face of suspicious circumstances); *see First Capital Inv. Holdings LLC v. Wilson Capital Grp., Inc.*, 2011 U.S. Dist. LEXIS 57368, at *15-16 (S.D.N.Y. May 23, 2011) (noting that financially sophisticated investors had a "duty to exercise ordinary diligence and conduct an independent appraisal of the risk they were assuming"); *Kosovich v. Metro Holmes LLC*, No. 09 Civ. 6992 (JSR), 2009 U.S. Dist. LEXIS 121390, at *10-11 (S.D.N.Y. Dec 30, 2009) ("An absence of justifiable reliance defeats a securities fraud claim, and because this element involves inquiry into what a *reasonable* investor should have done, [an investor's] professed financial cluelessness is beside the point if *he acted unreasonably*." (emphasis added)). Other courts have analyzed the issue of a plaintiff's reliance from the perspective of a plaintiff's recklessness. *See, e.g., Mallis v. Bankers Trust Co.*, 615 F.2d 68, 79 (2d Cir. 1980) (Friendly, J.). Courts uniformly examine the objective facts and circumstances when determining the reasonableness of an investor's reliance.

Defendants' conduct here yields the same effect as under the fraudulent conveyance laws: the Defendants are, as alleged, deemed on notice of the fraud. In the face of the circumstances set forth in the Complaint that would suggest to reasonable investors that their BLMIS investments might be the product of fraudulent activity, the Defendants had a duty to inquire. That duty to inquire was heightened as a result of the hints of falsity surrounding the Defendants' investments and by virtue of their sophistication.

Moreover, the Sterling Partners' duty to investigate the legitimacy of their BLMIS investments was elevated further by virtue of their role as a fiduciary. Beginning in 1996, they coordinated with Madoff in the formation and administration of a BLMIS investment option for their employees' 401(k) plan for which two of the Sterling Partners served as plan trustees. (Compl. ¶¶ 974-982.)[18] By December 2008, approximately 90% of the 401(k) plan was invested with BLMIS. (*Id.* ¶ 752.) Yet, the Defendants concede that they conducted little diligence into BLMIS during the 1980s and admit that they conducted no due diligence into BLMIS at any time in response to any of the facts of which they became aware beginning in or about 2000 that called for investigation. (Compl. ¶¶ 752-53, 914; Tr.'s Br. 33-35.)

The Second Circuit's decision in *Crigger v. Fahnestock* is informative here. In *Crigger*, the jury returned a verdict dismissing the fraud claims against the defendants. The plaintiff-investors appealed, asserting that the district court had: (i) improperly instructed the jury that the investors were under a duty to investigate their investments commensurate with their

[18] *Liss v. Smith*, 991 F. Supp. 278, 297 (S.D.N.Y. 1998) ("It is … black-letter ERISA law that 'the most basic of ERISA's investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment.' . . . 'The failure to make any independent investigation … of a potential plan investment has repeatedly been held to constitute a breach of fiduciary obligations."); *Secs. & Exch. Comm'n v. Milan Capital Grp., Inc.,* No. 00 CIV. 108 (DLC), 2000 WL 1682761, at *5 (S.D.N.Y. 2000) ("A variety of circumstances may raise enough questions about the legitimacy of an investment to make a person's failure to investigate before recommending that investment reckless.").

sophistication; and (ii) improperly declined to charge the jury that the investors' negligence was not a bar to their fraud claim. *Crigger*, 443 F.3d at 235-36.

The Second Circuit upheld the district court's jury instructions, finding they "accurately and clearly set out the plaintiffs' duty of investigation, given the suspicious circumstances and plaintiffs' savvy." *Id.* at 236. The Second Circuit also reasoned that the plaintiff-investors' proposed jury instruction that their own negligence was not a bar to a fraud claim, "would run counter to the principle . . . that New York law generally requires a plaintiff to employ such wit and experience as he has to look into an investment when the circumstances would alert such an investor to pause and inquire." *Id.* at 236.

Notably, the evidence adduced at trial in *Crigger* described facts remarkably similar to many of the allegations in the Complaint. In *Crigger*, the plaintiff-investors had substantial experience with millions of dollars in investments; worked with financial advisors and accountants prior to investing in the Ponzi scheme; failed to heed their accountants' warnings about the investment; were told to make no unauthorized direct contact with the company in which they were investing "on pain of being 'automatically disqualified' from participation;" and each of the plaintiff-investors testified at trial that the investment was "something along the lines of 'too good to be true.'" *Id.* at 236.[19]

So too here. (Compl. Sect. VI, VIII-X.) As this Court noted in *First Capital*:

> Also, while, 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. Since the plaintiffs and their principals are financially

[19] The Second Circuit held that "these circumstances created a fact question as to whether these sophisticated investors, exercising reasonable prudence, should have been sufficiently alerted to look into the legitimacy of the proposed transactions, and avoid the loss," and that the jury evidently decided that plaintiffs failed to investigate the investment in a manner commensurate with their level of sophistication. *Crigger*, 443 F.3d at 236.

> sophisticated, they "had a duty to exercise ordinary diligence and conduct an independent appraisal of the risk they were assuming."
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> ****
>
> All the while, plaintiffs appear not to have conducted the slightest due diligence; for example, they made no effort to find out whether Wilson Capital even had a "trade program." Whether such blindness was a product of gullibility or greed, it at least creates a triable issue of whether plaintiffs' reliance on defendants' representations was reasonable and justifiable.[20]

Id at *15-16 (citation omitted)*; see also Pub. Emps. Ret. Sys. of Miss. v. Merrill Lynch*, 714 F.Supp.2d 475, 480 (S.D.N.Y. 2010) ("[W]hether a plaintiff had sufficient facts to place it on inquiry notice is often inappropriate for resolution on a motion to dismiss . . . ." (citation and marks omitted)).

In sum, the Trustee has alleged detailed facts showing that the Defendants had repeated warnings regarding Madoff's fraud, but closed their eyes to the facts which called for investigation, instead choosing for business and financial reasons not to inquire. Because analogous securities laws and common law would impose the same duty to inquire upon Defendants under the foregoing circumstances, BLMIS's insolvency and the fraudulent conveyance laws which govern their good faith defense do not operate to retroactively alter the Defendants' diligence obligations.[21] The Defendants have not and simply cannot meet their

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[20] S*ee AXA Vericherung AG. v. N.H. Ins. Co.*, 391 Fed. App'x 25, 35 (2d Cir. 2010) (vacating jury's approximately $35 million award to plaintiffs for fraudulent inducement, barring claims on limitations grounds, reasoning that a reasonable reinsurer like plaintiff could not "continue to turn a blind eye to repeated circumstances indicating that it may be a victim of a fraud").

[21] The Defendants also remain subject to the long-established law that they cannot keep other customers' stolen money unless they are bona fide purchasers for value. The same fundamental principles underlying the securities laws, common law and fraudulent conveyance law that operate to impute notice of the fraud to the Defendants for failing to inquire would also preclude their assertion of a bona fide purchaser defense. "[W]here a purchaser has knowledge of any fact, sufficient to put him on inquiry as to the existence of some right or title in conflict with that he is to purchase, he is presumed either to have made the inquiry and ascertained the extent of such prior right, or to have been guilty of a degree of negligence equally fatal to his claim, to be considered as a bona fide purchaser." *Williamson v. Brown,* 15 N.Y. 354, 362 (1857). Thus,

burden on this motion of proving their good faith in connection with the Trustee's fraudulent conveyance causes of action. At a minimum, questions of material fact are in dispute and require discovery to proceed.

III. THE COMPLAINT PROPERLY STATES FRAUDULENT CONVEYANCE CLAIMS AGAINST THE DEFENDANTS

The Defendants' claim that SIPA creates an exception for "customers" from the avoidance of fraudulent transfers is wrong. (Tr.'s Br. 68-69.) The plain language of SIPA § 78fff-2(c)(3) explicitly authorizes and empowers the Trustee to avoid transfers to the full extent of the Code, expressly including transfers to or on behalf of customers:

> 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.

15 U.S.C. § 78fff-2(c)(3) (emphasis added).

This authority is not merely consistent with, but necessary to, Congress' goal of equitable treatment among customers, as demonstrated by both the plain language and legislative purpose of SIPA and its predecessor.[22]

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even though a party has paid valuable consideration for property transferred to him, and there is an absence of proof that the party was a participant in the vendor's fraud upon his creditors, courts nevertheless have rejected the bona fide purchaser defense where that party "had knowledge sufficient to put him on inquiry, if not actual notice, of the vendor's fraud." *Hall v. Frith*, 51 Misc. 600, 101 N.Y.S. 31, 34 (Sup. Ct. N.Y. Co. 1906).

[22] *See* REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECS. AND EXCH. COMM'N, H.R. DOC. NO. 95, at 411-12; Analysis of H.R. 12889, 74th Cong., 2d Sess. 193 (1936) (statement of Harry Zalkin) (purpose of authorizing trustee to avoid preferential and fraudulent transfers made to certain customers at expense of others was to effectuate provision calling for ratable participation in single and separate fund); *Hill v. Spencer Savings & Loan Association (In*

In addition, the Defendants' contention that the fabricated BLMIS customer statements created a valid obligation, rendering the transfers from BLMIS immune to the fraudulent conveyance laws, is based on the same faulty premise that Judge Lifland expressly and unequivocally rejected in the Bankruptcy Court's interpretation of "net equity" within the meaning of SIPA, now on appeal before the Second Circuit. (Tr.'s Br. 61-62.) And even if the BLMIS customer statements created obligations, as the Defendants claim, any such "obligations" and/or transfers to the Defendants would still be avoidable as actual and constructive fraudulent conveyances. The transfers from BLMIS to the Defendants are presumed, as a matter of law, to be actual fraudulent conveyances under Code § 548(a)(1)(A) and NYDCL § 276 because they were made during the course of a Ponzi scheme. (Tr.'s Br. 59-60, 71-76.)[23] The Bankruptcy

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the Matter of Bevill), 83 B.R. 880, 898 (D.N.J. 1988) (explaining SIPA's "purpose" "to restore and maintain the confidence of investors in the capital markets. . . is advanced by the equitable distribution of property. . . [a]doption of the new categories of customer property. . . in the 1978 amendments to SIPA were intended to cure certain inequities under the 1970 Act in the treatment of customers of the bankrupt broker."). *Hill* also rejected the defendant's claim that avoidance of a transfer by the debtor brokerage to customer's account amounted to a taking of defendant's property in violation of the Fifth Amendment because, among other things, the "case involve[d] only the prospective application of a bankruptcy law." *Id.* at 897. To the extent Defendants claim any unlawful retroactive taking in violation of the Fifth Amendment, their claim must fail as they have been on notice of SIPA and the Code's avoidance provisions since their enactment years before they opened their first BLMIS account. *See id.*

[23] Of the approximately $300 million in fictitious profits that this action seeks to recover, $140 million was withdrawn beyond six years of the Filing Date. The Trustee may properly pursue recovery of amounts transferred beyond the six years under New York's discovery rule—made applicable by § 544 of the Code—which sets the limitations period for a fraudulent conveyance action "commenced within six years after the commission of the fraud or within two years of the date the fraud was or should have been discovered [with reasonable diligence], [w]hichever is longer." *Picard v. Chais* (*In re Bernard L. Madoff Inv. Secs. LLC*), 445 B.R. 206, 232 (Bankr. S.D.N.Y. 2011). Standing in the shoes of an unsecured creditor (who need not be identified until trial), the Trustee has adequately pled that during the relevant period, "Madoff's fraud was either (1) not discovered and could not have been discovered with reasonable diligence by at least one unsecured creditor; or (2) was only discovered, and could only have been discovered with reasonable diligence, by at least one unsecured creditor within two years of the filing date." *Id.*; Compl. ¶¶ 1370-71; *see also In re Taubman*, 160 B.R. 964, 989-90 (Bankr. S.D. Ohio 1993) (holding under UFCA trustee in a Ponzi scheme not limited in the number of years he could

Court in the Dreier bankruptcy confirmed that fraudulent intent of the transferor is all that is required by the NYDCL. *See In re Dreier LLP*, 2011 WL 2412581, at *28-33 (review and rejection of caselaw holding that transferee intent is required under § 276).

Moreover, Madoff's transfers to the Defendants are constructively fraudulent under the Code and NYDCL because they were neither for "value" nor received in good faith. (Tr.'s Br. 58-60, 77-89.) When investors invest in a Ponzi scheme, payments by the debtor that exceed their investments are not made for reasonably equivalent value. (*Id.* at 77-80.) Even as to the principal invested, an investor in a Ponzi scheme does not, strictly speaking, provide "value" by the mere fact of its investment. A good faith investor generally would be entitled to a claim of rescission to recover the full amount of his investment due to the fraud perpetrated by the debtor. Here, however, these Defendants are not entitled to a claim for the equivalent of their principal investment since December 2002, because they lacked good faith at the time of the transfers, and for the same reasons set forth in Section II above, cannot state a fraud claim against the estate. (*See generally* Compl. Sects. IX and X.)

Finally, contrary to the Defendants' assertions, the Second Circuit's decision in *Sharp Int'l Corp. v. State Street Bank & Trust Co.* (*In re Sharp Int'l Corp.*), 403 F.3d 43 (2d Cir. 2005), does not preclude the avoidability of the transfers here. (Tr.'s Br. 66-68.) *Sharp* reiterates that where, as here, "actual intent to defraud creditors is proven, the conveyance will be set aside *regardless of the adequacy of consideration given*." *Sharp*, 403 F.3d at 56 (*citing U.S. v. McCombs*, 30 F.3d 310, 328 (2d Cir. 1994)) (emphasis added).

IV. SECTION 546(e) DOES NOT APPLY HERE

Defendants argue that other than intentional fraudulent transfers made within two years

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reach back to recover transfers where fraud was not discovered other than by debtor and co-conspirators).

of the commencement date, transfers made to them are not avoidable because they constitute transfers made by a "stockbroker" and "in connection with a securities contract." (Defs.' Withdrawal Br. 18-19.)[24] Defendants are incorrect.

A. Section 546(e) Does Not Apply To A Fiction

No court to consider the issue has extended the "safe harbor" provision of § 546(e)[25] to a Ponzi scheme that engaged in no relevant securities activity. As Judge Lifland stated, "[c]ourts have held that to extend safe harbor protection in the context of a fraudulent securities scheme would be to 'undermine, not protect or promote investor confidence . . . [by] endorsing a scheme to defraud SIPC,' and therefore contradict the goals" of § 546(e). *Picard v. Merkin* (*In re Bernard L. Madoff Inv. Secs., LLC*), 440 B.R. 243, 267 (Bankr. S.D.N.Y. 2011) (quoting *In re Adler*, *Coleman Clearing*, 247 B.R. at 105 (declining to grant safe harbor protection in fraudulent Ponzi scheme); *Kipperman v. Circle Trust F.B.O.* (*In re Grafton Partners*), 321 B.R. 527, 539 (9th Cir. BAP 2005) ("The few decisions that involve outright illegality or transparent manipulation reject § 546(e) protection.")); *see also Johnson v. Neilson* (*In re Slatkin*), 525 F.3d 805, 809, 816-19 (9th Cir. 2008) (holding that § 546(e) safe-harbor defense does not apply where debtor operated a Ponzi scheme because he was not "engaged in the business of effecting transactions in securities").

The purpose of § 546(e) is to protect securities transactions without destabilizing the

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[24] Defendants do not argue that the transfers constitute "settlement payments" for purposes of § 546(e). To the extent their submission of supplemental authority constitutes an attempt to invoke this language, it is inapplicable because no securities transaction relating to any alleged "settlement payment" was ever "completed." *In re Adomo*, 619 F.2d 216, 222 (2d Cir. 1980). Moreover, the Defendants' reliance on *In re Enron Creditors Recovery Corp. v. Alfa*, No. 09-5122-bk(L), 2011 U.S. App. LEXIS 13177 (2d Cir. June 28, 2011), is unfounded because that case merely interpreted the definition of "settlement payment" in connection with a preference, and there were, in fact, actual transactions that occurred in that case.

[25] Defendants concede that § 546(e) does not operate to preclude avoidance of intentional fraudulent transfers under § 548(a)(1)(A) of the Code. (Defs.' Withdrawal Br. 19.)

public or private markets involving actual transactions that do or could impact the markets generally. *In re Grafton Partners*, 321 B.R. at 532-33; *see also Merkin*, 440 B.R. at 267-68. However, here, no relevant securities transactions took place. Therefore, no statutory purpose would be served here where there are no transactions and some customers would be harmed at the expense of others. *Merkin*, 440 B.R. at 267-68. To the contrary, this result would authorize a fraud and contravene the statute. *Id.*; *Wider v. Wootton*, 907 F.2d 570, 573 (5th Cir. 1990) (refusing to apply § 546(e) where doing so "would lend judicial support to 'Ponzi' schemes by rewarding early investors at the expense of later victims") (quoting *In re Western World Funding, Inc*., 54 B.R. 470, 481 (Bankr. D. Nev. 1985)).

Courts in this District have identified five factors relevant to a consideration of whether the safe harbor applies to a particular transaction.[26] The most cursory review of these factors shows the utter irrelevance of § 546(e) to the transfers here: each of them presupposes an actual transaction. In short, "[i]t is relatively easy to conclude that Congress never could have meant to permit § 546(e) to protect transactions that themselves were assaults on the securities markets, as that would be a perversion of the statute's purpose." *Geltzer v. Mooney (In re MacMenamin's*

[26] These include whether:
(1) the transactions have long settled by means of actual transfers of consideration, so that subsequent reversal of the trade may result in disruption of the securities industry, creating a potential chain reaction that could threaten collapse of the affected market;
(2) consideration was paid out in exchange for the securities or property interest as part of settlement of the transaction;
(3) the transfer of cash or securities effected contemplates consummation of a securities transaction;
(4) the transfers were made to financial intermediaries involved in the national clearance and settlement system;
(5) the transaction implicated participants in the system of intermediaries and guarantees which characterize the clearing and settlement process of public markets and therefore would create the potential for adverse impacts on the functioning of the securities market if any of those guarantees in the chain invoked.
Alfa v. Enron Creditors Recovery Corp. (*In re Enron Creditors Recovery Corp.*), 422 B.R. 423, 439 (S.D.N.Y. 2009) (citations omitted).

Grill Ltd.), No. 09–8266 (RDD), 2011 WL 1549056, at *9 (Bankr. S.D.N.Y. Apr. 21, 2011) (Drain, J.).

B. The Transfers At Issue Were Not Made In Connection with a Securities Transaction

Defendants rely on the language in § 546(e) that the Trustee may not avoid "a transfer made by or to…[a] stockbroker…in connection with a securities contract." But the transfers here were not made in connection with a securities contract. BLMIS did not purchase, loan or sell any relevant securities. (Compl. ¶¶31-35.) The computer system upon which BLMIS purportedly conducted trades was not connected to any outside system; customer statements were entirely fabricated; and the only funds transferred to customers like the Defendants consisted of other people's money. (*Id.*); *In re Bernard L. Madoff Inv. Secs., LLC,* 424 B.R. 122, 127-28 (Bankr. S.D.N.Y. 2010).

Defendants rely on cases holding that Madoff's Ponzi scheme was a fraud "in connection with the purchase and sale of any security" for purposes of Rule 10b-5. (Defs.' Br. 83-84.) But Rule 10b-5 addresses the commission of fraud and making of false statements. Section 546(e), by contrast, regulates transfers. While Madoff made misrepresentations in connection with securities, this has nothing to do with the transfers he made to customers, which were made in connection with furthering his Ponzi scheme, not in connection with a securities contract. Rule 10b-5 is not relevant to this inquiry.[27]

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[27] Rule 10b-5 arises in the context of the very different remedial scheme of securities laws designed to prevent fraudulent misrepresentations or omissions in connection with securities purchases or sales under the Securities Exchange Act of 1934. Because broad interpretation of remedial legislation like Rule 10b-5 is appropriate to effectuate its remedial intent, fraud in connection with inducing the payment of money to purchase securities has been held by various courts to be within the scope of the Securities Exchange Act even in circumstances in which no purchases occurred. *In re J.P. Jeanneret Assocs., Inc.*, 769 F. Supp. 2d 340, 361 (S.D.N.Y. 2011) ("[t]he 'in connection with the purchase or sale' requirement [under Rule 10b-5 must be construed 'not technically and restrictively, but flexibly to effectuate its remedial purpose.'")

Finally, SIPA incorporates the provisions of the Code, but only to the extent that the Code is consistent with SIPA. *See* SIPA § 78fff(b). SIPA would not permit an interpretation of §546(e) that would apply to phantom securities transactions, where this would result not only in shielding the fraudulent transfers made by Madoff, but also preferring net winner customers to the exclusion and prejudice of the net loser customers—both of which would be flatly contrary to SIPA's policy of equitable treatment among customers.

C. Section 546(e) Is An Affirmative Defense

Section 546(e) applies, if at all, as an affirmative defense to claims brought by a trustee, and the burden of proof rests on the defendant. *Merkin*, 440 B.R. at 267; *see also Degirolomo v. Track World, Inc*. (*In re Laurel Valley Oil Co*.), No. 07-6109, 2009 WL 1758741, at *2-3 (Bankr. N.D. Ohio June 16, 2009). Unless its application is clearly established on the face of the Complaint, it "does not tend to controvert [the trustee's] prima facie case." *Merkin*, 440 B.R. at 267. Even assuming the statute had any relevance, here, where there was only the illusion of securities activity, Defendants cannot establish its application as a matter of law.

(quoting *Secs. & Exch. Comm'n v. Zandford*, 535 U.S. 813, 820–21 (2002)). The purpose of § 546(e), however, is to prevent the snowballing effect on the markets of unraveling securities transactions implicating the system of guarantees implicit in the clearance system for public securities. *In re Grafton Partners*, 321 B.R. at 532-33. As discussed above, endorsing the Ponzi scheme would undermine instead of promote investor confidence.

CONCLUSION

For the reasons discussed above and in the Trustee's Opposition, the Trustee respectfully requests that the Defendants' Motion to Dismiss be denied.

Date: July 22, 2011
New York, New York

By: /s/ David J. Sheehan
BAKER & HOSTETLER LLP
45 Rockefeller Plaza
New York, New York 10111
Telephone: (212) 589-4200
Facsimile: (212) 589-4201
David J. Sheehan
Email: dsheehan@bakerlaw.com
Fernando A. Bohorquez, Jr.
Email: fbohorquez@bakerlaw.com
Regina L. Griffin
Email: rgriffin@bakerlaw.com

Attorneys for Irving H. Picard, Trustee for the Substantively Consolidated SIPA Liquidation of Bernard L. Madoff Investment Securities LLC and Bernard L. Madoff