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

Attorneys for the Sterling Defendants

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IRVING H. PICARD, Plaintiff, - against - SAUL B. KATZ, et al., Defendants.	:	11-CV-03605 (JSR)

SUPPLEMENTAL MEMORANDUM OF LAW IN RESPONSE TO SUPPLEMENTAL MEMORANDA OF THE TRUSTEE AND SIPC AND IN FURTHER SUPPORT OF STERLING DEFENDANTS' MOTION TO DISMISS OR, IN THE ALTERNATIVE, FOR SUMMARY JUDGMENT

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The Sterling Defendants respectfully submit this supplemental memorandum of law in response to the supplemental briefs of the Trustee ("Trustee Supp. Br.") and SIPC ("SIPC Supp. Br.") and in further support of the Sterling Defendants' motion to dismiss or, in the alternative, for summary judgment dismissing the Complaint ("Motion").[1]

PRELIMINARY STATEMENT

In their fully submitted Motion, the Sterling Defendants seek dismissal of the Trustee's illegitimate Complaint. The Complaint seeks to avoid as fraudulent conveyances payments that discharged valid contractual obligations of BLMIS, a registered broker, to its customers, who were creditors. No fraudulent conveyance claim, intentional or constructive, may be stated where a payment discharged a valid obligation to a creditor. Under Article 8 of the NYUCC, a broker's obligation to a customer may be invalidated only if the customer was willfully blind, or complicit, in a broker's fraud. Because a customer has no duty to investigate his broker, willful blindness or complicity cannot be premised upon any breach of such duty. Neither SIPA nor the Bankruptcy Code retroactively changes that result. Nor does the result change because the broker's fraud turns out to be a Ponzi scheme.

The Complaint does not challenge the validity of BLMIS' obligations to its customers. Rather, the Complaint targets only the payments discharging those obligations, contending that, by failing to investigate BLMIS' operations, the Sterling Defendants were "willfully blind" to BLMIS' fraud. No duty to investigate exists, so a supposed failure to investigate cannot constitute "willful blindness." And the evidence

[1] Defined terms used herein have the same meaning as in the prior briefs submitted in support of the Sterling Defendants' Motion.

submitted by the Sterling Defendants demonstrates that all of the Trustee's claims of "willful blindness" are false or immaterial.

After withdrawing the reference of this adversary proceeding, the Court allowed supplemental briefing to consider three questions: (i) whether SIPA permits avoidance of transfers from brokers that discharge enforceable obligations to customers; (ii) whether SIPA or the Bankruptcy Code imposes a retroactive duty on customers to investigate their broker; and (iii) whether the application of Section 546(e) of the Bankruptcy Code in this case is incompatible with SIPA.

The supplemental briefs of the Trustee and SIPC essentially fail to address these or any of the key issues in this case. Neither acknowledges the legal relevance of BLMIS' status as a registered broker, or that Article 8 applies at all. Instead, both contend, implausibly, that Section 10(b) of the Exchange Act, the rules enacted thereunder, and New York common law impose a due diligence duty on customers of registered brokers, breach of which gives rise to massive liability. And both repeat, but do not support, the false allegations already discredited by the evidence offered in support of the Sterling Motion.

Finally, the Trustee argues that Section 546(e) does not apply in this SIPA case, contending that no statutory purpose would be served by its application and that, because no "securities transactions" took place, no "securities contracts" existed. The Trustee's argument is contrary to the Second Circuit's recent *Enron* decision, pursuant to which the plain meaning of Section 546(e) controls, and Section 546(e)'s objectives are served by application in this case.

ARGUMENT

I. TRANSFERS ON ACCOUNT OF ANTECEDENT DEBT CANNOT BE AVOIDED AS FRAUDULENT

The Complaint asserts fraudulent conveyance claims. To prove such a claim in this case, the Trustee must demonstrate that, at the time the targeted transfers were made, a Sterling Defendant received a transfer to which he was not entitled. Here, the Sterling Defendants had enforceable claims against BLMIS, under Article 8 of the NYUCC and the federal securities laws, for the securities reflected on their brokerage statements. BLMIS was legally obligated to make payments in respect of those statements. These legal rights and obligations were not changed by SIPA or the Bankruptcy Code after BLMIS' insolvency filing. Previously valid debt remained valid, as did payments made to discharge such debt. Therefore, although certain payments may be avoidable as fraudulent after an insolvency filing, that is not because SIPA or the Bankruptcy Code renders a valid debt invalid. It is because the debt being discharged was invalid in the first place. That is not the case here.

A. Under Applicable Non-Bankruptcy Law, Brokers Are Indebted to Customers for Cash and Securities on Brokerage Statements

BLMIS issued periodic statements to its customers, reflecting that BLMIS owed them blue-chip, Fortune 100 securities and cash. Under the NYUCC, when a broker sends such an acknowledgement to its customer—as required under federal securities laws—the customer acquires a securities entitlement and the broker incurs an obligation. NYUCC § 8-501(b)(1), (3). The "most important rule" is that "once a securities intermediary has acknowledged that it is carrying a position in a financial asset for its customer or participant, the intermediary is obligated to treat the customer or participant

as entitled to the financial asset." *Id.* § 8-501 cmt. 2. The broker is obligated whether or not the broker actually acquires or holds the securities. *Id.* § 8-501(c); *see also* § 8-501 cmt. 3. These rights and obligations are recognized and enforced by the federal securities laws.[2] (*See* Sterling Br. at 60-64; Sterling Reply Br. at 47.)

B. Customers Are Creditors As to Whom Payments Discharging Valid Antecedent Debt Cannot Be Avoided As Fraudulent

By virtue of the NYUCC, at the time of the targeted transfers the Sterling Defendants had "claims" against BLMIS.[3] BLMIS owed "debts" to its customers.[4] Those customers were "creditors" of BLMIS.[5] Consequently, when analyzed under the avoidance provisions of the Bankruptcy Code, the payments made by BLMIS were payments to creditors on account of antecedent debt.

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[2] *See, e.g.*, Concept Release on the U.S. Proxy System, Exchange Act Release No. 34-62495, 75 Fed. Reg. 42,982, 42,985 n.31 (July 22, 2010) (recognizing that the rights and interests that a customer has against a broker are created by contract and the UCC); *see also, e.g.*, Confirmation of Transactions, Exchange Act Release No. 34-34962, 59 Fed. Reg. 59,612, 59,614 n.29 (Nov. 17, 1994) (recognizing that the contract between a broker and its customers is made enforceable under the UCC by the written transaction confirmation).

[3] The Bankruptcy Code defines "claim" in relevant part as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A); *see also Pa. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 558 (1990) (citing legislative history describing definition of "claim" as "broadest possible").

[4] The Bankruptcy Code defines "debt" very broadly to mean "liability on a claim." 11 U.S.C. § 101(12); *see also Davenport*, 495 U.S. at 558 (discussing breadth of definition of "debt").

[5] The Bankruptcy Code defines "creditor" in relevant part as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A).

By definition, a payment to a creditor on account of valid antecedent debt is not a fraudulent transfer—it is at most a preference. "[A] conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another." *In re Sharp Int'l Corp.*, 403 F.3d 43, 54 (2d Cir. 2005) (internal quotation marks omitted); *see also Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 375 (S.D.N.Y. 2003), *aff'd*, 99 F. App'x 274, 281 (2d Cir. 2004) ("[I]t is hornbook law that [a] conveyance cannot be fraudulent as to creditors if . . . [it] does not deplete or otherwise diminish the value of the assets of the debtor's estate remaining available to creditors."); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995) ("[T]he preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because 'the basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them.'" (quoting *Boston Trading Group, Inc. v. Burnazos*, 835 F.2d 1504, 1509 (1st Cir. 1987))); (Sterling Br. at 58-60; Sterling Reply Br. at 50-51).

Thus, payments made by BLMIS that discharged valid debts to customers are not avoidable as fraudulent under either federal or state law. *See* 11 U.S.C. §§ 544, 548; NYDCL §§ 273-278; (*see also* Sterling Br. at 58-67; Sterling Reply Br. at 49-52). Contrary to the claims of both SIPC and the Trustee, the Sterling Defendants do not argue that the Trustee cannot assert any fraudulent transfer claim against a customer. The Trustee could do so if a transfer were, for example, for amounts in excess of what the broker owed according to a statement—though Section 546(e) of the Bankruptcy Code would limit any such claim to transfers made with actual intent to defraud within two

years of the filing date. But the transfers here *were* on account of valid debt, and, therefore, no fraudulent conveyance claim can be sustained.[6]

C. BLMIS' Obligations to a Customer May Be Invalidated Only by a Showing of Willful Blindness

Under the NYUCC, a customer's securities entitlement—which establishes the obligation of the broker—cannot be challenged under any legal theory unless the customer was on notice of an "adverse claim."[7]

> "An action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a security entitlement under Section 8-501 for value and without notice of *the* adverse claim." NYUCC § 8-502 (emphasis added).[8]

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[6] Also contrary to the claims of SIPA and the Trustee, the validity of the Trustee's fraudulent conveyance claims will not be decided by the Second Circuit. (Trustee Supp. Br. at 19; SIPC Supp. Br. at 17-18.) The Second Circuit has been asked to interpret SIPA § 78*lll*(11), which defines a customer's "net equity" claim against the SIPC Fund and the BLMIS estate. Although the Sterling Defendants argue that the definition must be interpreted by reference to the broker's obligation on its last customer account statement, the "net equity" definition has no bearing on the requisite elements of a fraudulent conveyance claim against a customer. If the Circuit were to decide the weight to be afforded customer statements in determining a customer's "net equity" claim, such guidance could be instructive, but it would not govern the legal questions at issue in this case. Indeed, the Bankruptcy Court, in rendering its "net equity" opinion, expressly disavowed deciding the merits of any defenses to avoidance. *See In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 137 n.30 (Bankr. S.D.N.Y. 2010).

[7] An "adverse claim" is a claim to a property interest in a financial asset such that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset. NYUCC § 8-102(a)(1).

[8] Sections 8-502 and 8-510, as revised, "require notice of the *particular* adverse claim that is asserted in order for a purchaser to lose its favored status." Frances Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 Fla. St. U. L. Rev. 615, 654 n.218 (2000) (emphasis added).

A person has notice of an adverse claim if:

> "(1) the person knows of the adverse claim;
>
> (2) the person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim; or
>
> (3) the person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim." NYUCC § 8-105(a).

The Complaint does not allege actual knowledge of Madoff's Ponzi scheme, and the Trustee's claim that Section 10(b) of the Exchange Act and the rules enacted thereunder imposed a duty of investigation on the Sterling Defendants is not credible. (*See infra* at 10-12.) Thus, in order to invalidate BLMIS' obligations to the Sterling Defendants, the Trustee must offer evidence of their "willful blindness."[9] NYUCC § 8-105(a)(2). As noted, he must show willful blindness not as to the source of BLMIS' payments, but as to the validity of its obligations. (*See supra* at 4-6; *see also* Sterling Br. at 64-70; Sterling Reply Br. at 50-53.) The Complaint does not challenge these obligations, and the Trustee has no evidence with which to mount any such challenge.[10]

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[9] The Trustee now claims that he uses the term "willful blindness" only as a descriptive phrase (Trustee Supp. Br. at 2 n.1), an implicit concession that the Sterling Defendants were not willfully blind. Whatever he may say, he must plead and prove that the Sterling Defendants had no valid securities entitlements because they were willfully blind to *the* fraud. He has done neither. (Sterling Br. at 6-47, 68-74; Sterling Reply Br. at 3-36.)

[10] If the Trustee alternatively were to attempt to invalidate the Sterling Defendants' securities entitlements on the ground that their creation violated the interests of other customers in particular financial assets held by the broker, his claim would be defeated by NYUCC Section 8-503. Under Section 8-503, the Trustee would have to plead and prove that the Sterling Defendants were acting in collusion with BLMIS to deprive other entitlement holders of their rights. NYUCC § 8-503(e). "Collusion" includes "acting in concert, acting by conspiratorial arrangement," or engaging in transactions with a securities intermediary with "actual knowledge that the securities

The Trustee has failed either to plead or prove that the Sterling Defendants were willfully blind to BLMIS' Ponzi scheme such that the creation of their securities entitlements violated the property rights of other brokerage customers, pursuant to their own securities entitlements. *See* NYUCC § 8-503(b).

1. "Willful Blindness" Is Akin to Knowledge

As discussed in the Sterling Motion, "willful blindness" is a culpable state of mind approximating actual knowledge. (Sterling Br. at 69-70; Sterling Reply Br. at 54.) NYUCC § 8-105(a)(2) codifies the "willful blindness" standard.

> "The first prong of the willful blindness test of paragraph (a)(2) turns on whether the person is aware of facts sufficient to indicate that there is a significant probability that an adverse claim exists. The 'awareness' aspect necessarily turns on the actor's state of mind. Whether facts known to a person make the person aware of a 'significant probability' that an adverse claim exists turns on facts about the world and the conclusions that would be drawn from those facts, taking account of the experience and position of the person in question. A particular set of facts might indicate a significant probability of an adverse claim to a professional with considerable experience in the usual methods and procedures by which securities transactions are conducted, even though the same facts would not indicate a significant probability of an adverse claim to a non-professional.
>
> The second prong of the willful blindness test of paragraph (a)(2) turns on whether the person 'deliberately avoids information' that would establish the existence of the adverse claim. The test is the character of the person's response to the information the person has. The question is whether the person deliberately failed to seek further information because of concern that suspicions would be confirmed." NYUCC § 8-105 cmt. 4.

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intermediary has violated or is violating an entitlement holder's property interest." *Id.* § 8-101 (Legislative Intent). "Collusion" is comparable to "willful blindness" and, thus, cannot be based on "rumors, allegations or reports of suspected wrongdoing" or on a failure to "inquire." *Id.* Therefore, even if this provision were applicable, the analysis would be no different—the Trustee has not demonstrated either "willful blindness" or "collusion."

As the Supreme Court recently held, willful blindness requires evidence of both guilty knowledge and evasive action: "(1) the defendant must *subjectively* believe that there is a *high probability* that a *fact* exists and (2) the defendant must take *deliberate actions* to avoid learning of that fact." *Global-Tech Appliances, Inc. v. SEB, S.A.*, 131 S. Ct. 2060, 2070 (2011) (emphasis added).

> "[T]hese requirements give willful blindness an appropriately limited scope that *surpasses recklessness and negligence.* Under this formulation, a willfully blind defendant is one who takes *deliberate* actions to avoid confirming a *high probability of wrongdoing* and who can *almost be said to have actually known* the critical facts." *Id.* at 2070-71 (emphasis added).

The Second Circuit has deemed willful blindness "tantamount to knowledge." *Tiffany Inc. v. eBay, Inc.*, 600 F.3d 93, 110 n.15 (2d Cir. 2010) (collecting cases). The standard therefore differs materially from a negligence, or "should have known," standard. *See, e.g.*, *Global-Tech*, 131 S. Ct. at 2070-71 (contrasting willful blindness with negligence); *see also, e.g.*, *Rosner v. Bank of China*, No. 06 CV 13562, 2008 U.S. Dist. LEXIS 105984, at *24 (S.D.N.Y. Dec. 18, 2008), *aff'd*, 349 F. App'x 637 (2d Cir. 2009) ("If such allegations [indicative of constructive knowledge] are insufficient to support a claim of actual knowledge, they are necessarily insufficient to support a claim of willful blindness; otherwise, the required element of actual knowledge would effectively be demoted to one of constructive knowledge."); *Kirschner v. Bennett*, 759 F. Supp. 2d 301, 334 (S.D.N.Y. 2010) ("Conscious avoidance therefore involves a culpable state of mind whereas constructive knowledge imputes a state of mind on a theory of negligence." (internal quotation marks omitted)).

Consequently, someone who is willfully blind must have actually suspected fraud and "*decided* not to learn the key fact, not merely to have failed to learn it through negligence." *United States v. Nektalov*, 461 F.3d 309, 315-16 (2d Cir. 2006) (emphasis added); *see also United States v. Abreu*, 342 F.3d 183, 188 (2d Cir. 2003) (rejecting argument "premised on the common misconception that the conscious avoidance theory allows the prosecution to establish knowledge by proving only that the defendant should have known of a certain fact, even if he did not actually know it").

2. Because a Brokerage Customer Has No Duty to Investigate His Broker, "Willful Blindness" Cannot Be Predicated on Breach of Any Such Duty

Lacking any evidence establishing the Sterling Defendants' "willful blindness," the Trustee relies instead on allegations that the Sterling Defendants failed to investigate BLMIS. Willful blindness, however, cannot be premised upon breach of a customer's duty to investigate a broker. There is no such duty. Extensive research has revealed no case finding such a duty, and no such case is cited by SIPC or the Trustee. No applicable statute or regulation imposes such a duty. On the contrary, the duties all run the other way—to the customer—especially where, as here, the broker is a fiduciary. (*See* Sterling Br. at 76.)

Finding no legal support for their position, and perhaps hoping to come within the ambit of NYUCC § 8-105(a)(3), SIPC and the Trustee now argue that Section 10(b) of the Exchange Act, Rules 10b-5 and 10b-10, and New York common law impose a supposed "duty of inquiry" upon brokerage customers. (Trustee Supp. Br. at 10-14; SIPC Supp. Br. at 19-24.) They are wrong.

Every case cited by the Trustee or SIPC concerns the limits on the assertion of a claim by the plaintiff, resulting from the plaintiff's own delay, or pleading or evidentiary failure.[11] *See, e.g.*, *Wood v. Carpenter*, 101 U.S. 135, 140-41 (1879) (plaintiff's fraud claim barred by statute of limitations); *Crigger v. Fahnestock & Co.*, 443 F.3d 230, 234-36 (2d Cir. 2006) (plaintiffs' fraud claims failed for lack of reasonable reliance on defendant's misrepresentations); *Schlaifer Nance & Co. v. Estate of Warhol*, 119 F.3d 91, 101 (2d Cir. 1997) (plaintiff's fraud claim dismissed for failure to establish reasonable reliance on defendants' misrepresentations); *Armstrong v. McAlpin*, 699 F.2d 79, 88-89 (2d Cir. 1983) (receiver's securities fraud claims barred by statute of limitations); *Cohen v. Cohen*, No. 09 Civ. 10230, 2011 U.S. Dist. LEXIS 33771, at *47-48, 63-65 (S.D.N.Y. Mar. 29, 2011) (plaintiff's civil RICO and common law claims barred by applicable statutes of limitations).

These cases address the rules under which an investor must assert his *own* claims. They certainly do not suggest that, if he fails to do so, he will then be liable to *someone else*. The failure to exercise reasonable diligence in making an investment or to preserve one's own rights—which may preclude a subsequent recovery for oneself—is not a breach of an affirmative duty to anyone that gives rise to liability.[12] These cases provide

[11] Notably, *SEC v. Milan Capital Group, Inc.*, No. 00 Civ. 108, 2000 U.S. Dist. LEXIS 16204 (S.D.N.Y. Nov. 9, 2000), emphasizes the duties that a broker—even an unregistered one—owes to its customers when dispensing investment advice. *See id.* at *14 ("A broker is under a duty to investigate the truth of his representations to clients, because 'by his position he implicitly represents he has an adequate basis for the opinions he renders.'").

[12] Even if brokerage customers had some duty of inquiry that, if breached, could expose them to liability to *other customers*—which they do not—the Trustee would lack standing to assert such a claim against the Sterling Defendants on their behalf. *See*

no authority for the Trustee's claim that a customer is obligated to investigate his broker for the benefit of others.

3. As a Matter of Law the Sterling Defendants Were Not "Willfully Blind" to Madoff's Ponzi Scheme

The Trustee has failed as a matter of law to meet his burden of proving "willful blindness." The Complaint is replete with false allegations that are entirely contradicted by the evidence the Trustee himself adduced in unilateral discovery *before* filing the Complaint. (Sterling Br. at 6-53; Sterling Reply Br. at 3-33.) In response to the Sterling Motion, the Trustee has offered *no* admissible evidence to refute the Sterling Defendants' evidence demonstrating the falsity of his allegations—instead, in his supplemental brief, the Trustee ignores the evidence and suggests that the allegations in his Complaint remain valid. They do not.

- The central allegation of the Complaint is that Sterling Stamos warned one of the Sterling Defendants that Madoff was a "scam" or a "fraud." That allegation, even if true, is not sufficient as a matter of law to establish "willful blindness." But the allegation is false, as demonstrated by the evidence the Trustee had adduced before the allegation was made. (Sterling Br. at 6-7; Sterling Reply Br. at 12-16.)

- In his opposition to the Sterling Motion, the Trustee shifted to a new central allegation—that the Sterling Defendants went on a "shopping spree" for Ponzi scheme insurance. That allegation is also insufficient as a matter of law to prove "willful blindness." And it is false based upon the evidence the Trustee had adduced before the allegation was made. (Sterling Reply Br. at 3-8.)

- The allegation now receiving top billing in the supplemental briefs—that the Sterling Defendants knew of industry articles in which industry professionals questioned Madoff's legitimacy (Trustee Supp. Br. at 8)—is immaterial. The

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Picard v. HSBC Bank PLC, No. 11 Civ. 763, 2011 U.S. Dist. LEXIS 82936, at *8 (S.D.N.Y. July 28, 2011). Nor can the Trustee bolster his claim by reference to a 401(k) plan trustee's fiduciary duties. No brokerage customer, including a 401(k) plan trustee, has a duty to engage in a forensic examination of a broker or investment advisor.

claim that these public articles were "red flags," even for financial professionals, has been rejected by numerous courts as insufficient to establish scienter. (Sterling Br. at 70-73.) Consequently, this allegation cannot be sufficient as a matter of law to demonstrate "willful blindness."

- None of the other allegations is sufficient to constitute "willful blindness" as a matter of law, and none is supported by admissible evidence in any event. Every one of the other allegations is false, irrelevant, or immaterial, or all three. (Sterling Br. at 6-47; Sterling Reply Br. at 3-33.)

- And the Trustee's entire $1 billion demand is based on an unsupported and unprecedented extension of imputation principles to impose liability on, among others, grandchildren, charitable foundations, and family trusts. (Sterling Br. at 87-91; Sterling Reply Br. at 59-65.)

Once the false and immaterial allegations are stripped from the fully submitted record, it is apparent that the entire willful blindness case, and the demand for $1 billion, is based upon emails sent after Madoff's arrest, which were sent neither to nor from a Sterling Defendant and which do not even remotely suggest that any Sterling Defendant was willfully blind to BLMIS' fraud. (Sterling Reply Br. at 12-14, 34-35.) Even if the hearsay statements in these unauthenticated emails were admissible, which they are not, they fail, as a matter of law, to establish that the Sterling Defendants knew "*facts* sufficient to indicate that there is a *significant probability*" of a Ponzi scheme. Nor are they evidence of *deliberate* avoidance of information that *would establish* the existence of a Ponzi scheme. Indeed, as the SEC's Office of Inspector General Report demonstrates, even when extremely detailed information was offered to a trained regulatory body, it did not see evidence of a Ponzi scheme. (Sterling Br. at 78-79.)

The Complaint is both factually and legally without merit. It is a profound attack on brokerage customers that has no precedent and that threatens the Sterling Defendants' rights under important federal and state non-bankruptcy laws. Contrary to the

contentions of the Trustee and SIPC, this action is not "the ordinary re-ordering and adjustment of creditor rights characteristic of bankruptcy." (SIPC Supp. Br. at 9, 17-18; *cf.* Trustee Supp. Br. at 19-20.) It is an affirmative demand for a huge sum of money to augment the debtor's estate, not to address "creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 56 (1989). The issues raised by the Complaint cannot and will not be determined through the claims process; indeed, the Trustee's letters rejecting the Sterling Defendants' claims did not even raise any of these issues. The Sterling Defendants, therefore, respectfully submit that this case must be heard in its entirety by an Article III court. *See Stern v. Marshall*, 131 S. Ct. 2594, 2616 (2011).

II. THE HAPPENSTANCE OF BANKRUPTCY DOES NOT RETROACTIVELY ALTER NON-BANKRUPTCY RIGHTS AND OBLIGATIONS OR IMPOSE NEW DUTIES

Before this SIPA case was filed, the Sterling Defendants had legally enforceable rights against BLMIS that had been discharged by valid payments from BLMIS. After the filing of this SIPA case, the Sterling Defendants still had legally enforceable rights against BLMIS that had been discharged by valid payments from BLMIS. Nothing in the Bankruptcy Code or SIPA, nor the fact that this case was ostensibly triggered by a Ponzi scheme, altered the legal status of those obligations and payments or retroactively imposed duties that did not previously exist.

A. A Bankruptcy Filing Does Not Alter Substantive Pre-Bankruptcy Rights

The filing of a bankruptcy case does not alter non-bankruptcy rights, but, rather, recognizes them as the foundation for analysis of claims and rights in a bankruptcy case.

The keystone of the legal architecture governing the interplay between bankruptcy law and non-bankruptcy law is *Butner v. United States*, 440 U.S. 48, 54 (1979), in which the Supreme Court unanimously held that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."

> "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" *Id.* at 55.

The *Butner* Court held that a creditor must be "afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued" and expressly rejected the view that the onset of bankruptcy permitted "undefined considerations of equity" to contravene state law. *Id.* at 56.

Later cases confirm *Butner*'s ruling. *See, e.g.*, *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-45 (1994) (rejecting avoidance of state foreclosure sale as fraudulent under 11 U.S.C. § 548 because state law precluded the Trustee's avoidance claim and "the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law" unless Congress's intent to the contrary is "'clear and manifest'"); *Barnhill v. Johnson*, 503 U.S. 393, 399-400 (1992) (relying upon the UCC to determine when a "transfer" by check occurred for purposes of preference avoidance); *Bear, Stearns Sec. Corp. v. Gredd*, 275 B.R. 190, 195-98 (S.D.N.Y. 2002) (dismissing billions of dollars of intentional fraudulent conveyance claims because Regulation T of the federal securities laws precluded the debtor from having an interest in the transferred property and

recognizing that "[b]ankruptcy does not provide a forum for the realignment of rights or priorities but serves only as a forum for the recognition of rights already acquired" (internal quotation marks omitted)).[13]

A critical objective served by this framework is commercial certainty. If bankruptcy were to change substantive legal rights, no one could be confident of the legal status of his actions. For example, the *BFP* Court expressed its concern that, if the commencement of a bankruptcy case caused the validity of a foreclosure sale to be questioned, "[t]he title of every piece of realty purchased at foreclosure would be under a federally created cloud." *BFP*, 511 U.S. at 544. Similarly, as the New York Court of Appeals has recognized in answering questions certified to it by the Second Circuit, "to permit in every case of the payment of a debt an inquiry as to the source from which the debtor derived the money, and a recovery if shown to have been dishonestly acquired, would disorganize all business operations and entail an amount of risk and uncertainty which no enterprise could bear." *Commodity Futures Trading Comm'n v. Walsh*, No. 91,

[13] To escape the "willful blindness" standard of proof, the Trustee and SIPC argue that bankruptcy law supersedes state law and, therefore, the "good faith" standard supersedes the "willful blindness" standard. (*See* Trustee Supp. Br. at 3-10; SIPC Supp. Br. at 10-19.) But as the Complaint does not challenge, and the Trustee cannot prove, that the Sterling Defendants' securities entitlements were invalid, he cannot state a claim for fraudulent conveyance, and the "good faith" defense to such a claim is irrelevant.

Further, where, as here, a specific statute sets out the standard by which a party to a transfer is to be judged, that standard necessarily must govern. *See, e.g.*, *Goldman v. Capital City Mortgage Corp. (In re Nieves)*, No. 08-2160, 2011 U.S. App. LEXIS 11704, at *17-18 & n.4 (4th Cir. June 10, 2011) (looking to compliance with industry practice to establish "good faith" standard). Therefore, "willful blindness" also must inform the "good faith" test.

2011 N.Y. LEXIS 1704, at *13 (N.Y. June 23, 2011) (quoting *Banque Worms v. BankAmerica Int'l*, 77 N.Y.2d 362, 372 (1991)).

The result would be the same if brokerage customers knew that they could not rely on the rights established by non-bankruptcy law when they engage in transactions with their broker. As the Second Circuit has recently remarked, "certainty and predictability are at a premium" in the area of law governing securities transactions. *See Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, No. 09-5122, 2011 U.S. App. LEXIS 13177, at *19 (2d Cir. June 28, 2011) ("*Enron*").

B. Nothing in SIPA Changes This Result

Nothing in SIPA alters the application of the *Butner* principles. Contending to the contrary, the Trustee and SIPC point to SIPA § 78fff-2(c)(3) to claim that SIPA permits fraudulent conveyance claims against customers. (Trustee Supp. Br. at 18; SIPC Supp. Br. at 15-18.) But the Sterling Defendants do not argue that the Trustee is precluded from asserting fraudulent conveyance claims against customers in appropriate circumstances—only that he cannot do so in an attempt to avoid payments on account of antecedent debt. This is so because "the powers of a SIPA trustee are still, as indicated, cabined by Title 11." *HSBC*, 2011 U.S. Dist. LEXIS 82936, at *11 (citing to SIPA § 78fff-2(c)(3)).

Section 78fff-2(c)(3), like the rest of SIPA, *protects* customers. It does not create a platform from which the Trustee may attack their long-settled expectations.[14]

[14] In the case of many of the Sterling Defendants, those settled expectations reach back more than twenty years, far outside any limitations or repose period. Although the Trustee contends he may exceed the statutory bar to bringing his claims under New

> "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).

It is true that under this section, property held by the broker, which under state law is property of the customers, is deemed to be property of the debtor for avoidance purposes, because only transfers of debtor property can be avoided. But this fiction is necessary for the assertion of *any* avoidance claim—preference or fraudulent conveyance—and the rest of this section makes plain that it is intended to enable *preference*, not *fraudulent conveyance*, claims. A preference claim avoids a transfer to a "creditor." 11 U.S.C. § 547(b)(1). A creditor is an "entity that has a claim against the debtor." 11 U.S.C. § 101(10)(A). A transfer to a creditor is, therefore by definition, a payment on antecedent debt. Although such a transfer may be avoided as preferential, it cannot be avoided as fraudulent. *See* 11 U.S.C. §§ 544, 548. Because under some state law customers might not be considered "creditors," SIPA § 78fff-2(c)(3) makes it easier to bring preference claims against customers by deeming them to be creditors for avoidance purposes. If Congress had intended in Section 78fff-2(c)(3) to enable

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York's "discovery rule," there is no support for this contention, nor has the Trustee met his evidentiary burden to come forward with an unsecured creditor to support his claim.

fraudulent conveyance claims, Congress would have provided that customers were *not* to be considered creditors. Congress did the opposite.[15]

The Trustee and SIPC also contend that they are permitted to sidestep altogether the rules governing fraudulent conveyances by arguing that the challenged payments are avoidable simply because they were made with "other people's money." (*See, e.g.*, Trustee Supp. Br. at 17 n.21; SIPC Supp. Br. at 8, 23; Trustee Opp. at 1, 5, 92; SIPC Opp. at 26-27.) This contention also ignores applicable law. First, under the principles enunciated in *Sharp* and *Boston Trading*, if a payment discharges a valid debt, the payment does not harm the creditor body and the origin of funds is irrelevant. (*See supra* at 4-6; *see also* Sterling Br. at 58-66; Sterling Reply Br. at 50-53.) Second, under Article 8, no tracing concept may displace the "willful blindness" standard for challenging a securities entitlement held in the indirect holding system. "The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system." NYUCC § 8-503 cmt. 2. Therefore, to avoid the payments, the Trustee must invalidate the entitlements. He cannot do so by relying upon the "other people's money" mantra.

[15] SIPA § 78fff-1(a) confirms this reading of Section 78fff-2(c)(3) by defining the Trustee's powers to include the right to avoid "preferences." This reading is consistent with SIPA's enactment as a securities law and with its objective of customer protection. Although evening out recoveries within 90 days of an insolvency filing by use of the preference avoidance power serves an equalization function, the severe disruption that avoidance of transfers to customers over several decades would cause is contrary to the entire structure established by the securities laws as a whole.

III. BY ITS PLAIN MEANING, SECTION 546(E) APPLIES IN THIS CASE

Section 546(e) of the Bankruptcy Code "stands 'at the intersection of two important national legislative policies on a collision course—the policies of bankruptcy and securities law.'" *Enron*, 2011 U.S. App. LEXIS 13177, at *14. As set forth in the Sterling Motion, Section 546(e) balances these competing objectives by precluding the avoidance of transfers made by a "stockbroker or financial institution . . . in connection with a securities contract," unless the transfers occurred within two years of a filing and were intentionally fraudulent under 11 U.S.C. § 548(a)(1)(A). (Sterling Br. at 80-84; Sterling Reply Br. at 55-58.) Since the briefing of the Sterling Motion was completed, the Court of Appeals for the Second Circuit has confirmed that Section 546(e) must be given a plain meaning interpretation. *Enron*, 2011 U.S. App. LEXIS 13177, at *16-17 (holding that, under the plain meaning of Section 546(e)'s "settlement payment" safe harbor provision, pre-petition redemptions of commercial paper could not be avoided).

Under the plain meaning of Section 546(e), the Trustee "may not avoid" as preferential any of the transfers at issue, as they were made by a stockbroker (BLMIS) or financial institution (JPMorgan Chase) in connection with a securities contract. No transfer may be avoided as fraudulent either, except as to transfers within two years of the filing date and for which the proof required by Section 548(a)(1)(A) is offered. The Trustee does not and cannot contest this analysis. Instead, he represents that BLMIS traded no securities for customers, and, therefore, the purpose of Section 546(e) would not be furthered by its application in this case. He also argues that there were no "securities contracts" pursuant to which payments were made. Both arguments must fail.

First, in applying Section 546(e) to the redemption of commercial paper, the Second Circuit recognized that the scope of Section 546(e) is broad and its objectives would not be served by limiting its application to specific factual scenarios. Relying on analogous reasoning that "undoing long-settled leveraged buyouts would have a substantial impact on the stability of the financial markets, even though *only* private securities were involved and *no* financial intermediary took a beneficial interest in the exchanged securities during the course of the transaction," the Court saw no reason why undoing Enron's long-settled redemption payments would not also have a "substantial and similarly negative effect on the financial markets." *Enron*, 2011 U.S. App. LEXIS 13177, at *26-27 (emphasis added).

The same reasoning applies here. In this case, the plain meaning of Section 546(e) must be applied, as mandated by *Enron*. But its application is entirely consistent with its purpose. In this litigation alone the Trustee seeks to undo a billion dollars worth of settled transactions between the Sterling Defendants and BLMIS—transactions that occurred over more than twenty years. Indeed, he seeks to avoid similar transfers to thousands of securities customers in nearly 1000 cases. Avoidance of thousands, if not millions, of transactions between a registered broker and its customers over many decades surely would have a "substantial and negative" impact on the financial markets and would completely undermine the balance between avoidance and commercial certainty and predictability established by Congress in Section 546(e).

Second, since the enactment of the provision at issue in *Enron*, Congress has expanded the scope of Section 546(e) even further to provide a safe harbor for transfers "in connection with a securities contract." "Securities contract" is defined broadly in the

Bankruptcy Code, *see* 11 U.S.C. § 741(7), and includes no purchase or sale requirement. Ignoring the breadth of this definition, the Trustee contends that no securities contracts existed because BLMIS conducted no trades. This contention is without merit. BLMIS defrauded its customers and breached its contracts to buy and sell securities, but those contracts did not become retroactively void by virtue of that fraud. Securities contracts existed, and the payments made by BLMIS were consistent with its obligations under those securities contracts. The plain meaning application of Section 546(e) protects those payments from avoidance in accordance with its terms.

CONCLUSION

For the reasons set forth above and in the Sterling Defendants' Motion, the Sterling Defendants respectfully request entry of judgment dismissing the Complaint pursuant to Rules 12(b)(6) and 56 of the Federal Rules of Civil Procedure.

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DAVIS POLK & WARDWELL LLP

By: /s/ Karen E. Wagner

Karen E. Wagner
Dana M. Seshens
450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800

Attorneys for the Sterling Defendants

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