UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, *et al.*, Defendants.	Adv. Pro. No. 10-05287 (BRL) Case No. 11 Civ 3605 (JSR)

MEMORANDUM OF LAW OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO STERLING DEFENDANTS' MOTION TO WITHDRAW THE REFERENCE

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TREATISES:

The Securities Investor Protection Corporation ("SIPC") submits this memorandum of law in opposition to the motion ("Motion") of the defendants in this case ("Defendants") to withdraw the reference from the United States Bankruptcy Court for the Southern District of New York ("Bankruptcy Court") of Adversary Proceeding No. 10-05287 (BRL), captioned *Picard v. Katz, et al.* That action was filed by Irving H. Picard ("Trustee"), trustee for the substantively consolidated proceedings of Bernard L. Madoff Investment Securities LLC ("BLMIS" or "Debtor") under the Securities Investor Protection Act, 15 U.S.C. §78aaa *et seq.* ("SIPA"), and Bernard L. Madoff ("Madoff").[1]

STATEMENT OF THE ISSUE

The Motion presents the following issue:

> Whether under 28 U.S.C. section 157(d), withdrawal of the reference of an adversary proceeding arising in a liquidation proceeding under SIPA is warranted and/or appropriate where:
>
> 1) SIPA mandates the removal of the liquidation proceeding to the bankruptcy court;
>
> 2) to the extent consistent with SIPA, the liquidation proceeding generally is to be conducted "in accordance with" and "as though it were being conducted under" Title 11;
>
> 3) the adversary proceeding presents only "core" claims that arise directly under Title 11;
>
> 4) withdrawal of the reference of the adversary proceeding would interfere with the Bankruptcy Court's consideration of matters that Congress has deemed to be within the basic competence of that court; and

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

Under SIPA §78eee(d), SIPC is "a party in interest as to all matters arising in a liquidation proceeding, with the right to be heard on all such matters . . . ."

5) many Defendants in the adversary proceeding filed claims in the liquidation proceeding, thereby submitting themselves to the jurisdiction of the Bankruptcy Court.

SIPC respectfully submits that under the facts presented, withdrawal of the reference to the Bankruptcy Court of the adversary proceeding is neither warranted nor appropriate.

STATEMENT OF FACTS

This is a suit by the Trustee to recapture for the benefit of BLMIS customers stolen BLMIS customer funds transferred to Defendants. The Defendants include Sterling Equities ("Sterling") partners ("Partners"), their family members, their related trusts, and various entities they own, operate, and control. *See* Complaint at §V.B.[2]

As alleged in the Complaint, Defendants were among the largest beneficiaries of the BLMIS Ponzi scheme. Over their 25-plus year relationship with BLMIS, Defendants received hundreds of millions of dollars in fictitious profits from BLMIS. *Id.* at §I. In total, Defendants received $300 million in fictitious profits and over $700 million in principal (together, the "Transfers") from BLMIS. *Id.* at ¶ 13. Because BLMIS ran a Ponzi scheme, none of the funds received by the Defendants were generated through investment, but instead were stolen customer monies.

From a handful of accounts in 1985, the number of BLMIS accounts opened and administered by Sterling Partners grew to 483 accounts. Of these, 305 accounts were held by the Partners, their family members, related trusts and other related entities. The rest were opened by them for friends, business acquaintances, and Sterling employees, all of whom were steered to

[2] A copy of the Amended Complaint ("Complaint") in this case is Exhibit A to the Declaration of Karen E. Wagner In Support of the Motion to Withdraw the Reference, filed herein.

invest with Madoff. *Id.* at ¶¶677-678. 185 of the accounts are the subject of the Trustee's Complaint. *Id.* at ¶678.

Money from the Defendants' BLMIS accounts flowed through every aspect of the Sterling Partners' businesses, including their real estate, major league baseball holdings, and private equity businesses. *Id.* at ¶¶ 4, 692. The Sterling Partners relied on Madoff's consistent and steady returns as a source of liquidity to develop their businesses and secure various bank credit facilities. *Id.* at ¶ 4-8. Notably, the stolen BLMIS customer funds reached the Defendants not only through the Defendants' withdrawals from their BLMIS accounts, but in other ways. Thus, the Sterling Partners invested through Madoff and Madoff invested in them. While Madoff's investment in Sterling real estate investment vehicles was done by Madoff in the names of his wife, Ruth, and his brother, Peter, the Trustee alleges, upon his information and belief, that the investments were paid for by the transfer to Sterling of at least $11.4 million in stolen customer funds from BLMIS bank accounts. *Id.* at ¶695. In return, the first such investment in a Sterling fund yielded a rate of return to Madoff of over 50%. *Id.* at ¶¶775-778.

Because the BLMIS money was so deeply entrenched within the Sterling empire, the Defendants willfully turned a blind eye to the fraud at BLMIS. *Id.* at ¶9. Although sophisticated, the Sterling Partners failed to conduct any diligence on Madoff or BLMIS before investing their fortune with him, or before starting their own hedge fund as another way to receive the impossibly consistent returns from BLMIS. *Id.* at ¶12. The Complaint details the various indicia of fraud that should have triggered the Defendants to investigate BLMIS but which they failed to do because it would not have financially benefitted them. *Id.* at Section IX. Defendants' failure to heed the red flags allowed the BLMIS Ponzi scheme to flourish while

Defendants reaped the spoils. It is on this basis that the Trustee seeks the return of fictitious profits and principal.

The Complaint asserts eleven causes of action, all "core" claims arising under the Bankruptcy Code or related state law. Specifically, the Trustee seeks to avoid the Transfers as (i) actual fraudulent transfers under Bankruptcy Code sections 544, 548(a)(1)(A), 550(a), and 551 and New York Debtor and Creditor Law; (ii) constructive fraudulent transfers under Bankruptcy Code sections 544, 548(a)(1)(B), 550(a), and 551 and New York Debtor and Creditor Law; and (iii) preferential transfers under Bankruptcy Code sections 547(b), 550(a), and 551. In addition, the Trustee seeks to disallow the claims filed in the BLMIS liquidation proceeding by many of the Defendants, or, to the extent any of their claims are allowed, equitably to subordinate the claims pursuant to Bankruptcy Code sections 510(c)(1) and 105(a). Consistent with 11 U.S.C. section 502(d), the Trustee has deferred his determination of many of the claims until after this adversary proceeding is resolved.

SUMMARY OF THE ARGUMENT

The Motion is an unwarranted attempt to remove to this Court matters within the Bankruptcy Court's "core" jurisdiction and competence. The Complaint asserts traditional avoidance actions, as well as claims for disallowance and equitable subordination of Defendants' customer claims. All of the Trustee's claims constitute "core" matters within the meaning of Subsections 157(b)(2)(A), (B), (F), (H), and (O) of Title 28.

Notwithstanding the Bankruptcy Court's clear authority, in a brazen attempt at forum shopping, Defendants attempt to recast traditional avoidance actions as "novel" issues of law, and to relitigate issues that have been decided by the Bankruptcy Court and are *sub judice* before the Second Circuit. While asserting inconsistencies between Title 11 and SIPA, Defendants

overlook the fact that SIPA itself is the source of the applicability of Title 11. Defendants argue that withdrawal is appropriate because resolution of the proceeding requires consideration of Title 11 and other federal laws apart from the bankruptcy statutes. They ignore, however, that Title 11 applies here only by virtue of, and *because of*, SIPA, which provides that the proceeding is to be conducted "in accordance with" and "as though" it were being conducted under Title 11. With some exceptions not applicable here, SIPA makes the liquidation provisions of Title 11 applicable to the proceeding, including more specifically, all of its avoidance provisions.

At bottom, resolution of the adversary proceeding under the facts of this case requires the Bankruptcy Court to consider no issue out of the ordinary for it. Indeed, carried to its logical extreme, Defendants' position would require the Court to withdraw the reference as to *every* matter in a SIPA liquidation, no matter how prosaic and clearly within the purview of the bankruptcy court's powers. Thus, their position would place before the District Court disputes as fundamental to bankruptcy as whether claims against an estate should be allowed, simply because the claims are filed in a SIPA liquidation proceeding, a purported "non-bankruptcy law."

In a further sleight of hand aimed at creating grounds for a mandatory withdrawal, Defendants repeatedly mischaracterize SIPA and misstate the law on fraudulent and preferential transfers. Among other things, Defendants are incorrect that a SIPA trustee can only bring preference actions and cannot sue customers for fraudulent transfers. They are also incorrect in their interpretation that Bankruptcy Code section 546(e) immunizes Defendants from their receipt of stolen customer funds. More relevant to the instant Motion, however, determination of whether Bankruptcy Code section 546(e) applies requires consideration of the Bankruptcy Code, not any other federal law. Accordingly, consideration of section 546(e) cannot warrant mandatory withdrawal. The Defendants are further incorrect in their premise that antecedent

debt -- a concept that derives from the avoidance provisions of the Bankruptcy Code -- can form the basis of mandatory withdrawal.

Beyond the fact that in filing claims in the liquidation proceeding, Defendants have submitted themselves to the jurisdiction of the Bankruptcy Court, their argument for withdrawal is unsound. Judicial economy would hardly be served by withdrawing this proceeding from the court presiding over the underlying liquidation and the over 1,000 other related adversary proceedings. The Bankruptcy Court is intimately familiar with all aspects of the underlying liquidation and the related litigation and is best equipped to preside over all that litigation efficiently. Accordingly, this proceeding should remain in that court.

ARGUMENT

I. THE STANDARDS FOR WITHDRAWAL ARE NOT MET

A. Standards Governing Mandatory Withdrawal

28 U. S. C. section 157(d) governs withdrawal of the reference to the bankruptcy court, and provides for both mandatory and discretionary withdrawal. The section mandates the district court to withdraw that reference where "[t]he court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." *Id.* The purpose of this provision is to reserve to the federal district courts those issues that Congress "intended to have decided by a district judge rather than a bankruptcy judge." *In re Johns-Manville*, 63 B.R. 600, 602 (S.D.N.Y. 1986).

Because the language of Section 157(d)'s mandatory withdrawal provision, if read literally, would eliminate much of the work of the bankruptcy courts, the district courts are cautioned to construe this sentence "narrowly." *In re Adelphi Institute, Inc.*, 112 B.R. 534, 536 (S.D.N.Y.

1990) ("*Adelphi*"). In fact, Section 157(d) does not mandate withdrawal unless the district court makes an affirmative determination that resolution of the matter in question will require "substantial and material consideration" of non-Title 11 federal statutes. *See In re Ionosphere Clubs, Inc.*, 922 F.2d 984, 995 (2d Cir. 1990), *cert. den. sub nom., Air Line Pilots Ass'n, Intern., AFL-CIO v. Shugrue*, 502 U.S. 808 (1991); *Adelphi*, 112 B.R. at 536. This standard is stringent, and is designed to ensure that the mandatory withdrawal provisions of Section 157(d) do not become "an escape hatch for matters properly before [the bankruptcy] court." *Adelphi*, 112 B.R. at 536 (*quoting In re Johns-Manville Corp.*, 63 B.R. 600, 603 (S.D.N.Y. 1986)).

B. Standards Governing Permissive Withdrawal

Section 157(d) also permits a district court to withdraw the reference, *inter alia*, "[o]n a timely motion of any party, for cause shown." Courts in this jurisdiction consider a number of factors in determining whether "cause" for a discretionary withdrawal of the reference exists. The Second Circuit, however, has emphasized that the threshold question is whether a claim is core or non-core. *See In re Orion Pictures Corp.*, 4 F.3d 1095, 1101-02 (2d Cir. 1993), *cert. dismissed*, 511 U. S. 1026 (1994) ("*Orion Pictures Corp.*"). In fact, determination of this question has a profound impact on the relevance of many of the factors often considered in connection with a motion for discretionary withdrawal, including, for example, whether judicial efficiency is best served by withdrawal of the reference. *See, e.g., Orion Pictures Corp.*, 4 F.3d at 1101 (explaining that "questions of efficiency and uniformity will turn" on whether a claim is core or non-core).

Neither mandatory nor permissive withdrawal is warranted here.

II. A SIPA PROCEEDING IS TO BE CONDUCTED AS A BANKRUPTCY PROCEEDING

The matters in the Complaint herein are typically considered by bankruptcy courts. That this adversary proceeding arises in the context of a SIPA liquidation is immaterial. At least two sections of SIPA, 78eee(b)(4) and 78fff(b), make that clear.

A. The History and Purposes of Section 78eee(b)(4)

Section 78eee(b)(4) is headed "Removal to Bankruptcy Court" and specifies that upon the issuance of the customer protective decree and appointment of a trustee, the district court "shall forthwith order the removal of the entire liquidation proceeding to the court of the United States in the same judicial district having jurisdiction over cases under title 11." The relevant case law under, and history of, SIPA illustrate that Congress intended SIPA proceedings to be considered by the bankruptcy courts.

Although the original version of SIPA did not expressly include a removal or referral provision, the Second Circuit concluded in *Exchange National Bank of Chicago v. Wyatt*, 517 F.2d 453 (2d Cir. 1975) ("*Wyatt*"), that referral of the proceedings to the bankruptcy courts carried out the purposes of SIPA. In doing so, the court examined 1) section 5(b)(2) of SIPA, 15 U.S.C. §78eee(b)(2) (1970), giving to the district courts exclusive jurisdiction over the debtor and its property and the powers of a bankruptcy court and of a court in a proceeding under chapter X of the Bankruptcy Act;[3] 2) section 6(c)(1), 15 U.S.C. §78fff(c)(1) (1970), providing

[3] In 1970, while specifying that a debtor under SIPA would not be reorganized, SIPA incorporated provisions of the Bankruptcy Act applicable to reorganization proceedings. *See* S. Rep. No. 91-1218, at 13 (1970), and *Redington v. Touche Ross & Co.,* 612 F.2d 68, 71-72 (2d Cir. 1979). In 1978, Congress deleted the reference to the reorganization provisions and expressly made the liquidation provisions applicable. Pub. L. No. 95-283, 92 Stat. 249, 259 (1978), and Pub. L. No. 95-598, 92 Stat. 2549, 2675 (1978). *See Hearings on H.R. 8331 Before*

that the SIPA proceeding would be conducted "in accordance with, and as though it were being conducted under," specified provisions of the Bankruptcy Act; and 3) section 6(c)(2), 15 U.S.C. §78fff(c)(2) (1970), setting forth provisions that were unique to a SIPA liquidation. The Second Circuit observed that since section 22 of the Bankruptcy Act, providing for a general reference of cases to referees in bankruptcy, was contained in a chapter of the Bankruptcy Act which was applicable to a SIPA proceeding, reference of the SIPA proceeding would be proper. 517 F.2d at 456. The power of the district court to refer SIPA proceedings to referees in bankruptcy was not only "consistent with the purposes of SIPA but essential." 517 F.2d at 457. Thus, there was no difference in the processing of customer claims, at issue in that case, as performed in a SIPA liquidation and as performed in an ordinary bankruptcy liquidation. Indeed, the conduct of such proceedings, for practical reasons, was best left to the bankruptcy courts. As the Second Circuit observed:

> The process for the determination of ["customer"] claims [in a SIPA proceeding] did not differ in any significant respect from what would have been required in a large stockbroker bankruptcy before enactment of SIPA; the difference lies in the supersession of §60, sub. e of the Bankruptcy Act by the somewhat altered Special Provisions of §6(c)(2) of SIPA and the entitlement of "customers" as therein defined to benefit from the SIPC Fund. *This is the kind of business for which bankruptcy judges have developed special expertness and administrative skills and which Congress did not intend to dump on already overburdened district courts without needed clerical and other facilities.*

517 F.2d at 457-58 (emphasis added).[4]

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the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 95th Cong., at 175-76 (1977).

[4] That the bankruptcy court is best-equipped to handle the liquidation of financially failing securities broker-dealers finds support in *S.E.C. v. American Bd. of Trade, Inc.*, 830 F.2d 431, 436-438 (2d Cir. 1987). *See also* Anthony Michael Sabino, *The Role of Bankruptcy Courts in Stockbrokerage Liquidations*, 16 Sec. Reg. L. J. 227 (Fall 1988). In *American Board of Trade*, the Second Circuit expressed misgivings over the use of a district court equity receivership to

Congress's intent that SIPA matters be heard by bankruptcy courts was made clear twice in 1978, when it first amended the statute to include section 78eee(b)(4), and when, several months later, it revised that section to its current form. The provision initially authorized the district court "at any stage of the [SIPA] proceeding, [to] refer the proceeding to a referee in bankruptcy to hear and determine any or all matters, or to a referee in bankruptcy as special master to hear and report generally or upon specified matters." Pub. L. No. 95-283, 92 Stat. 249, 257 (1978). In adding the section, Congress explained that "[a]uthority for the existing practice of referring all or part of a liquidation proceeding to a referee in bankruptcy, thereby in many cases expediting liquidation proceedings, is clarified. See, e.g., [*Wyatt*]." S. Rep. No. 95-763, at 10 (1978). *See also* H.R. Rep. No. 95-746, at 27 (1977).

Subsequently, section 308 of Title III of the Bankruptcy Reform Act of 1978 made certain amendments to SIPA to conform it to the Bankruptcy Code. *See* S. Rep. No. 95-989, at 19 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5805. Section 78eee(b)(4) was amended to its present form, providing for removal to the "court of the United States in the same judicial district having jurisdiction over cases under title 11." Pub. L. No. 95-598, 92 Stat. 2549, 2674 (1978). The intended court was the bankruptcy courts because under 28 U.S.C. §1471(c), Pub. L. No. 95-598, 92 Stat. 2668 (1978), the bankruptcy courts would exercise all of the jurisdiction of the district courts including jurisdiction over Title 11 cases.[5]

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effect the liquidation of insolvent entities, stating that the district court had undertaken to oversee routine bankruptcy matters, "without the aid of either the experience of a bankruptcy judge or the guidance of the bankruptcy code." 830 F.2d at 438. The Second Circuit admonished that in the future, such receiverships were not to be continued "beyond the point necessary to get the estate into the proper forum for liquidation -- the bankruptcy court." *Id.* at 437.

[5] Ultimately, section 1471(c) did not become effective pursuant to section 402(b) of Pub. L. No. 95-598, as amended. It is noteworthy that the broader powers conferred upon the bankruptcy courts nevertheless remained unchanged in SIPA section 78eee(b)(4). Whether the jurisdiction

Although SIPA was thereby brought in line with the broader jurisdiction and powers which the 1978 Bankruptcy Reform Act conferred upon bankruptcy courts, Congress already independently had demonstrated its intent that SIPA liquidation proceedings be considered by the bankruptcy courts. Thus, in section 78eee(b)(4), as originally enacted, Congress expressly provided for referral of all or part of the proceedings to bankruptcy referees to make clear its intent, because such referrals would "expedite" the liquidations. When considered with SIPA section 78fff(b), *infra*, making Title 11 provisions applicable to a SIPA proceeding, the intent of current section 78eee(b)(4) is plain that except for the special protection afforded customers,[6] SIPA liquidation proceedings are to be administered no differently than ordinary Title 11 bankruptcies.

B. <u>The Removal Clause of Section 78eee(b)(4)</u>

Under 28 U.S.C. section 1334(b), federal district courts generally have "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." Initially, 28 U.S.C. section 1334(b) vests jurisdiction over Title 11 cases, proceedings, and related proceedings, in the district courts. The district courts may then refer the cases and proceedings to the bankruptcy courts. 28 U.S.C. §157(a). To implement section

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and powers of a bankruptcy court in a SIPA case are broader than in ordinary bankruptcy is not at issue, as the bankruptcy court under the facts of the case at hand would exercise no broader jurisdiction and powers than it would in ordinary bankruptcy.

[6] In a SIPA proceeding, "customers" share on a priority basis and *pro rata* in "customer property," that is, property received, acquired or held for them by the broker. To the extent such property is insufficient to satisfy a customer claim, the customer is eligible to have his claim satisfied through an advance of funds by SIPC – up to $500,000 of which up to $100,000 (raised to $250,000 in 2010) may be used to satisfy the portion of a claim that is for cash only. If the customer's claim is still unsatisfied, the customer shares in any general estate, *pro rata*, with unsecured general creditors. *See* SIPA §§78*lll*(2) and (4); 78fff-2(c)(1); and 78fff-3(a).

157(a), this District Court issued an order on July 10, 1984, under which all Title 11 cases and proceedings, and proceedings arising in or related to Title 11 cases, are referred to the bankruptcy judges for the district. In a similar vein, SIPA preliminarily vests jurisdiction over SIPA cases in the district courts, §78eee(b)(2), and then requires the district courts to remove them to the bankruptcy courts. §78eee(b)(4).

The main distinction between section 157(a) and SIPA is that referral under section 157(a) is discretionary with the district courts while removal under SIPA is mandatory. As a practical matter, the difference between an automatic referral and a mandatory removal is insignificant. The district court's authority to withdraw a case or proceeding under section 157(d) can be reconciled with removal under SIPA. While section 78eee(b)(4) does not provide for a withdrawal, it does not prohibit it. Thus, like the district court in an ordinary bankruptcy case, the district court in a SIPA case, if necessary, also could withdraw any portion or all of a SIPA case or proceeding.

C. Section 78fff(b) Supplies An Additional Basis for the Exercise of Jurisdiction

Under 28 U.S.C. section 157(b)(1), the bankruptcy court exercises the district court's jurisdiction with respect to all cases under Title 11 and all "core" proceedings arising under Title 11, or arising in a case under Title 11, referred by the district courts. In the context of 28 U.S.C. §157(b)(1), SIPA section 78fff(b) supplies an additional basis for the exercise of jurisdiction by the bankruptcy courts.

There are two operative requirements in the first sentence of section 78fff(b). To the extent consistent with SIPA, the SIPA liquidation proceeding is to be conducted 1) "in accordance with" and 2) "as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." The provisions of Title 11 referred to in section

78fff(b) are the bankruptcy liquidation provisions of the Code, except for the stockbroker and commodity broker provisions. In order for the SIPA liquidation to be conducted "in accordance with" Title 11, the bankruptcy provisions, including sections 105(a), 502(d), 510, 544, 547, 548, 550(a) and 551, relied upon here, must be held to apply in a SIPA liquidation. *Cf.*, *National Union Fire Insurance Co. of Pittsburg, PA. v. Camp (In re Government Securities Corp.)*, 972 F.2d 328, 330-331 (11th Cir. 1992), *cert. den.*, 507 U.S. 952 (1993).

Furthermore, because the SIPA liquidation must be conducted "as though it were being conducted" under the straight bankruptcy provisions of Title 11, the procedures that apply to Title 11 actions also must be deemed to apply to actions in SIPA liquidations. In the context of an ordinary bankruptcy case, this adversary proceeding raises "core" matters under 28 U.S.C. 157(b)(2)(A), (B), (F), (H), and (O), which automatically would be referred to the Bankruptcy Court under an Order issued by this Court on July 10, 1984, and would be heard and considered by that court under 28 U.S.C. §157(b)(1). If the second requirement of section 78fff(b) is to be implemented, there can be no different outcome here merely because the adversary proceeding is brought within a SIPA liquidation. The fact that a SIPA liquidation is simply an outright bankruptcy proceeding for all practical purposes has been consistently recognized. *See* SIPA §78fff(a). *See also Wyatt*, 517 F.2d at 457-459; *SIPC v. Ambassador Church Finance/Development Group, Inc.*, 788 F.2d 1208, 1210 (6th Cir.), *cert. den. sub nom.*, *Pine Street Baptist Church v. SIPC*, 479 U.S. 850 (1986); *In the Matter of Lewellyn*, 26 B.R. 246, 253 (Bankr. S.D. Iowa 1982); *SEC v. Albert & Maguire Securities Co.*, 378 F. Supp. 906, 909, 911 (E.D. Pa. 1974) (SIPA's predecessor was section 60e of the Bankruptcy Act). An adversary proceeding involving "core" matters brought in the context of a SIPA liquidation therefore should be adjudicated no differently than the same proceeding in a bankruptcy case. *See, e.g.*,

Turner v. Davis Gillenwater & Lynch (In re Investment Bankers Inc.), 4 F.3d 1556, 1563 (10th Cir. 1993), *cert. den.*, 510 U. S. 1114 (1994) (holding that the bankruptcy court had jurisdiction to determine avoidance actions in a SIPA liquidation); *In re Blinder, Robinson & Co.*, 135 B.R. 899, 901 (D. Colo. 1992).

III. DEFENDANTS SUBMITTED THEMSELVES TO THE JURISDICTION OF THE BANKRUPTCY COURT BY FILING PROOFS OF CLAIM

The fact that prior to being sued by the Trustee, many of the Defendants filed claims in the BLMIS liquidation proceeding reinforces the conclusion that the Bankruptcy Court is the appropriate court for the adjudication of the suit against them. Indeed, under 11 U.S.C. section 502(d), the Trustee cannot allow the Defendants' otherwise valid claims unless the Defendants return to the estate property that is the subject of an avoidable transfer.

The Supreme Court, as well as the Court of Appeals for the Second Circuit, has made clear that filing a claim submits a party to the bankruptcy court's equitable jurisdiction for determination of that claim and any proceedings related to determination of that claim, even if it is non-core. *See Langenkamp v. Culp*, 498 U.S. 42 (1990) (per curiam) (*"Langenkamp"*) ("Respondents filed claims against the bankruptcy estate, thereby bringing themselves within the equitable jurisdiction of the Bankruptcy Court."); *Bankruptcy Services Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 529 F.3d 432, 466 (2d Cir. 2008). The Supreme Court reasoned that any action to recover estate assets is "integral to the restructuring of the debtor-creditor relationship through the bankruptcy court's *equity jurisdiction*." *Langenkamp*, 498 U.S. at 44 (emphasis in original). *See also U. S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n. (In re U. S. Lines, Inc.)*, 197 F.3d 631, 637 (2d Cir. 1999), *cert. den.*, 529 U. S. 1038 (2000).

By filing claims in the liquidation proceeding, Defendants submitted themselves to the jurisdiction of the Bankruptcy Court, and cannot now argue that the Bankruptcy Court should not have equitable jurisdiction over them. *See, e.g., First Fid. Bank N.A., N.J. v. Hooker Invs. Inc. (In re Hooker Invs., Inc.)*, 937 F.2d 833, 838 (2d Cir.1991) ("[A] creditor who invokes the bankruptcy court's equitable jurisdiction to establish a claim against a debtor's estate is also subject to the procedures of equity in the determination of preference actions brought on behalf of the estate."). As the Supreme Court remarked in *Katchen v. Landy*, 382 U.S. 323, 335 (1966):

> "By presenting their claims respondents subjected themselves to all the consequences that attach to an appearance . . . .
>
> * * * *
>
> "... That requirement is in harmony with the rule generally followed by courts of equity that, having jurisdiction of the parties to controversies brought before them, they will decide all matters in dispute and decree complete relief." [*quoting Alexander v. Hillman,* 296 U. S. 222 (1935)].

Here, all counts in the Complaint are expressly identified as "core" claims in 28 U.S.C. section 157. *See* 28 U.S.C. § 157(b)(2)(B),(F), (H). As such, they are clearly within the jurisdiction of the Bankruptcy Court. *Id.*

IV. DEFENDANTS RAISE NO ISSUE OF LAW OUTSIDE OF TITLE 11

Defendants contend that SIPC argues for an expansion of the Trustee's powers beyond the Bankruptcy Code. To the contrary, SIPC supports the Trustee's position that a SIPA Trustee is vested with the same power to avoid transfers as a bankruptcy trustee. In fact, Defendants' arguments that the Trustee's powers are limited to those of a bankruptcy trustee show that mandatory withdrawal is improper, as Defendants raise no issue requiring interpretation of Title 11 alone.

A. Consideration of Only Well-Established Law under Title 11 Is Required

The outcome that Defendants urge – that Defendants are somehow immune from avoidance actions by virtue of their customer status or the SIPA liquidation – is inconsistent with Title 11 and well-established law.

As a preliminary matter, SIPC respectfully disagrees that SIPA is not a bankruptcy statute. Although the provisions of the Securities Exchange Act of 1934 apply as if SIPA were a part of that Act, they apply only "except as otherwise provided in [SIPA]." SIPA §78bbb. The "except as otherwise provided in SIPA" refers to the incorporation of Title 11 provisions into the SIPA proceeding under SIPA section 78fff(b). In fact, SIPA is a hybrid statute, that is, both a securities and a bankruptcy law. *See In re Bernard L. Madoff Inv. Securities LLC*, 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010), *appeal pending*, No. 10-2378-BK(L) (2d Cir.) ("In the context of this [SIPA] hybrid proceeding (U.S.C. Titles 11 and 15)"). The fact that the statute appears in Title 15 does not make it a non-bankruptcy law. Although SIPA has been designated to Title 15 by employees of the House of Representatives, *see* 2 U.S.C. §285b(4), that designation has never been endorsed by Congress. Where Congress has not enacted a codification into positive law, the statute in the Statutes at Large is the legal evidence of the law. *See* 1 U.S.C. § 204(a).

Moreover, as previously mentioned, a SIPA liquidation is conducted not only in accordance with, but as though it were being conducted under, specified chapters and subchapters of the Bankruptcy Code, to the extent consistent with SIPA. §78fff(b). One of the chapters is chapter 5. Chapter 5 of the Bankruptcy Code includes section 548, the fraudulent conveyance section. Contrary to the Defendants' assertions, there is no provision in SIPA that makes section 548 unavailable in any respect to a SIPA trustee. To limit the Trustee in his ability to recover assets in avoidance would be inconsistent with his obligation to liquidate the

Debtor and in the process, to resolve all claims against the Debtor by satisfying claimants to the maximum extent possible.

A liquidation under SIPA contemplates satisfaction of certain customer claims, the liquidation of the debtor's business, and the satisfaction of claims filed by general creditors. *See* §§78fff(a)(4) and 78fff-2(a)(3). To accomplish those ends, the trustee has the same powers as a Chapter 7 bankruptcy trustee, and additional powers that enable him to perform the special functions of a SIPA liquidation. *See* SIPA §78fff-1(a). *See also Executive Securities Corp. v. Doe, 702 F.2d 406, 407 (2d Cir.), cert. den., 464 U. S. 818 (1983); SIPC v. Christian-Paine & Co.*, 755 F.2d 359, 361 (3d Cir. 1985); *SEC v. Albert & Maguire Sec. Co.*, 560 F.2d 569, 574 (3d Cir. 1977); *Gold v. Hyman*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,043 at 97,657- 97,658 (S.D.N.Y. 1975).

Because the Trustee's responsibilities extend not only to stockbroker customers but to the entire bankruptcy estate, *In the Matter of Lewellyn*, 26 B.R. 246, 253-254 (S.D. Iowa 1982), the Trustee may sue to recover assets to satisfy general creditors, unpaid customers and SIPC, as subrogee. *See Gold v. Hyman, supra,* at 97,657; *Bondy v. Chemical Bank*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,360 at 98,784, 98,785--98,786 (S.D.N.Y. 1975). Toward that end, among other things, since enactment, SIPA has conferred upon the SIPA trustee the powers of a bankruptcy trustee to avoid transfers. As succinctly stated in 3 *Collier on Bankruptcy* ¶60.85 at 1246 (14th ed. 1977):

> The trustee, therefore, has all the powers conferred by the Bankruptcy Act upon an ordinary bankruptcy trustee to avoid or set aside transfers of property or other transactions occurring prior to institution of the proceedings, to recover property and collect the assets of the estate or to assert any right or defenses the debtor might have against the claims of others .... In short, whenever an ordinary bankruptcy trustee could under the Bankruptcy Act invalidate a transaction or transfer, the SIPA trustee can do the same, and the fact that he was appointed under SIPA does not suggest a different rule.

See 1 *Collier on Bankruptcy* ¶12.14[3] at 12-70 (16th ed. 2011). *See also Mishkin v. Ensminger (In re Adler Coleman Clearing Corp.)*, 218 B.R. 689, 702 (Bankr. S.D.N.Y.1998) (holding that a SIPA trustee may bring fraudulent transfer claims under the Bankruptcy Code); *Klein v. Tabatchnick*, 418 F.Supp. 1368 (S.D.N.Y. 1976), *aff'd in part and rev'd in part*, 610 F.2d 1043 (2d Cir. 1979) (unresolved factual questions making summary judgment improper); *Bondy v. Chemical Bank, supra*, at p. 98,786; *SEC v. North American Planning Corp.*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,326 at 98,640 (S.D.N.Y. 1975) ("[SIPA] Trustee alone has the power to recover property which has been fraudulently, preferentially or otherwise voidably transferred.")

B. "Customers" Are Not Immune From Fraudulent Transfer Actions

With regard to fraudulent transfer laws, customers in a SIPA liquidation are not afforded special treatment, and Defendants are no exception. The purpose of fraudulent transfer provisions is to benefit all customers as a class. Defendants specifically concede as much. *See* Defendants' Memorandum of Law (Dkt. No. 2) ("Def. Mem.") at 9, *quoting In re Chase & Sanborn Corp.,* 813 F.2d 1177, 1181 (11th Cir. 1987) ("Fraudulent transfers are avoidable because they diminish the assets of the debtor to the detriment of all creditors."). Here, Defendants received transfers of funds that belonged to all customers, not Defendants alone. Recovery of these fraudulent transfers is necessary for the equitable treatment of *all* customers. Thus, instead of bolstering their own position, Defendants' argument actually supports the Trustee's own position.

Defendants are also wrong on the law: "customer" status does not prevent a trustee from bringing a fraudulent transfer action against a transferee. Courts uniformly have held that a trustee has standing to avoid fraudulent transfers against customers. As observed in *SIPC v. S.J.*

Salmon, No. 72 Civ. 560, 1973 U. S. Dist. LEXIS 15606 (S.D.N.Y. Aug. 8, 1973) ("*Salmon*"), just a little more than two years after the enactment of SIPA:

> ...[I]t is argued that the trustee's position in seeking to reverse the February 2d transactions is contrary to the purpose of SIPA. There is no validity to this point of view. It is true that SIPA was intended to afford greater protection to customers than they enjoyed under §60e of the Bankruptcy Act, essentially by providing a limited form of insurance for customer claims for cash and securities. But SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stockbroker-debtors in SIPA proceedings. While SIPA was intended to protect customers there is nothing in its provisions to indicate that less preferred creditors are to be denied the protection of the provisions which bar a debtor from making fraudulent transfers at their expense.

Id. at *31.

At issue in *Salmon* were "trades" that the SIPA trustee alleged were neither *bona fide* nor the result of arm's length transactions in the open market, but recorded only on the books and records of the brokerage in order to improve the eligibility for SIPA protection of certain preferred customers in the face of the imminent liquidation of the firm. The trustee objected to the claims of the preferred customers, on the grounds that, among other things, the transactions were avoidable under the former Bankruptcy Act and New York Debtor and Creditor Law. In ruling in favor of the trustee, the Court concluded that the "trades" were transfers made with actual intent to defraud creditors, a deliberate attempt to defraud SIPC under SIPA, and done without "fair consideration." Id. at *31-32.

That a SIPA trustee may sue customers for fraudulent transfers has been recognized in other cases as well. *See, e.g., Picard v. Taylor (In re Park South Securities, LLC)*, 326 B.R. 505, 512-13 (Bankr. S.D.N.Y. 2005) (holding that the trustee had standing to bring fraudulent transfer claims against customers); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 496 (S.D.N.Y. 2001) ("*Adler, Coleman*") (affirming this Court's judgment that fraudulent

transfers to customers were avoidable); *see also Focht v. McDermott (In re Old Naples Securities, Inc.),* 343 B.R. 310, 320-21 (Bankr. M.D. Fla. 2006) (finding that fraudulent transfers to introducing broker were avoidable).

Sound reasoning underscores the decisions reached in these cases. A SIPA trustee's ability to recover fraudulent transfers is necessary for the equitable treatment of customers and other creditors alike. As stated in *Adler, Coleman*, 263 B.R. at 479, *citing Young v. Higbee Co.*, 324 U.S. 204, 210 (1945):

> [T]he spirit that infuses the whole of SIPA and the Bankruptcy Code is Congress's determination, reflected in a trustee's avoidance powers under [Bankruptcy Code] § 548 as well as SIPC Rule 300.503, that "a few individuals should not be allowed to benefit from transfers by an insolvent entity at the expense of the many."[7]

Thus, there can be no dispute that a SIPA Trustee has the power to avoid fraudulent transfers, whether made to a "customer" under SIPA, a general creditor, or a third party transferee.

C. Section 546(e) of the Bankruptcy Code Does Not Apply to This Case

Section 546(e) of the Bankruptcy Code, the "stockbroker defense," provides a "safe harbor" by exempting from avoidance certain types of payments commonly made in connection with transactions in the securities markets. Defendants rely upon that portion of section 546(e) that provides that notwithstanding specified provisions under the Code, "the trustee may not avoid a transfer that is ... a transfer made by or to ... [a] stockbroker [or] financial institution, ... in connection with a securities contract, as defined in section 741(7), ... that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." Defendants contend

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[7] SIPC Rule 503(a), 17 C.F.R. §300.503(a), specifies that "[n]othing in these Series 500 Rules shall be construed as limiting the rights of a trustee in a liquidation proceeding under [SIPA] to avoid any securities transaction as fraudulent, preferential, or otherwise voidable under applicable law."

that the sums paid to them by BLMIS were "transfers" that the Trustee may not now seek to avoid.

By definition, section 546(e) does not present an issue worthy of mandatory withdrawal, as section 546(e) is a provision of Title 11. Determining whether section 546(e) applies requires looking to law under Title 11, not any other law. *See, e.g.*, *Gredd v. Bear Stearns Sec. Corp. (In re Manhattan Fund),* 359 B.R. 510, 516 (Bankr. S.D.N.Y.), *aff'd in part and rev'd in part*, 397 B.R. 1 (S.D.N.Y. 2007) (stating that § 546(e) prevents the avoidance of margin payments when actual fraud is present); *Kipperman v. Circle Trustee 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"); *Wider v. Wootton,* 907 F.2d 570, 572 (5th Cir.1990) (holding § 546(e) inapplicable to customers of a Ponzi scheme).

To apply section 546(e) contravenes its purpose. Thus, the provision was intended "to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." H. R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.[8] Congress sought to prevent the "ripple effect" created by "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market." *Bevill, Bresler & Schulman Asset Mgt. Corp. v. Spencer Sav. & Loan Ass'n,* 878 F.2d 742, 747 (3d Cir. 1989). *See Enron Corp. v. Bear, Stearns Int'l Ltd. (In re Enron Corp.),* 323 B.R. 857, 864 (Bankr. S.D.N.Y. 2005) ("The purpose of

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[8] Section 546(e) was amended under the Financial Netting Improvements Act of 2006, to include the language relied upon by the Defendants. *See* Pub. L. No. 109-390, §5(b)(1), 120 Stat. 2692, 2697-2698 (2006). The amendment did not alter the fundamental purpose of the section, namely, to address the risk that the failure of one financial entity would disrupt or endanger the financial markets. H. R. Rep. No. 109-648 (part 1) at 3 (2006), *reprinted in* 2006 U.S.C.C.A.N. 1585, 1587.

section 546 is 'to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions.'"), *citing Kaiser Steel Corp. v. Charles Schwab & Co., Inc. (In re Kaiser Steel Corp.),* 913 F.2d 846, 848 (10th Cir. 1990). Where no transactions were effected, as in this case, because all transactions were fiction, there can be no market disruption or "ripple effect."

V. DEFENDANTS ARE INCORRECT THAT "ANTECEDENT DEBT" IS TO BE MEASURED ACCORDING TO THE FICTITIOUS ACCOUNT STATEMENTS

The Defendants contend that the amounts that they received can only be avoided, if at all, as preferences, and not fraudulent conveyances, because each transfer, in their view, was on account of an antecedent debt. Def. Mem. at 9-18. They argue that the "antecedent debt" arose from BLMIS's obligation to pay them what appeared on their account statements. These statements were fictitious, reflecting non-existent trades and equally non-existent profits. Nevertheless, in support of their position that the measure of what they are owed is the last account statement, Defendants cite to the Uniform Commercial Code and decisions under the federal securities laws. Although their arguments are made in the context of a SIPA proceeding, and SIPA defines how a broker's indebtedness to a customer is to be measured, they effectively ignore SIPA, no doubt because it runs counter to their position. In addition, Defendants cannot point to authority that this result would be any different under the Bankruptcy Code. Thus, it is the Defendants who argue for entirely "novel" interpretations of the law while the Trustee's position here is completely congruent with Title 11.

What customers are owed in a SIPA proceeding is their "net equity," as defined in SIPA section 78*lll*(11). As the Bankruptcy Court has held in the liquidation proceeding, net equity is the difference between the amounts customers deposited with the brokerage and amounts

withdrawn by them. *In re Bernard L. Madoff Investment Securities LLC*, 424 B. R. 122 (Bankr. S.D.N.Y. 2010), *appeal docketed,* No. 10-2378-BK(L) (2d Cir.). Defendants' Motion is an improper attempt to have this Court review the Bankruptcy Court's decision notwithstanding that unless reversed by the Second Circuit before which it is *sub judice*, the decision is the law of the case by which the parties to this adversary proceeding are bound. *See Gindes v. United States*, 740 F.2d 947, 950 (Fed. Cir.), *cert. den.*, 469 U. S. 1074 (1984) ("[T]he law of the case [is] the rule that 'a decision by the court on a point in a case becomes the law of the case unless or until it is reversed or modified by a higher court'"). The Bankruptcy Court properly construed the definition of net equity and what BLMIS investors are owed. The Defendants' assertions notwithstanding, this decision is entirely in line with the law under Title 11, and neither the Uniform Commercial Code nor the securities laws provisions upon which they rely, change that.

A. <u>The Uniform Commercial Code</u>

Defendants argue that the New York Uniform Commercial Code ("UCC"), instead of SIPA, governs what a customer is entitled to receive. *See* Def. Mem. at 12-14. The argument fails on at least two grounds.

First, to the extent that state law is inconsistent with SIPA which is a federal law, the state law is preempted under the Supremacy Clause of the United States Constitution. *See* U.S. Const., Art. VI, cl. 2; *In re Bevill, Bresler & Schulman, Inc.*, 59 B.R. 353, 378 (D.N.J.), *appeal dismissed*, 802 F.2d 445 (3rd Cir. 1986) (holding that state law that is inconsistent with SIPA is preempted). It is particularly appropriate that state law not override federal law where the federal law, as in SIPA, is supported both by the Bankruptcy Clause of the United States Constitution and the Commerce Clause. *See S.E.C. v. Albert & Maguire Sec. Co.*, 378 F.Supp. 906, 911 (E.D. Pa. 1974). *See also In re Bell & Beckwith*, 104 B. R. 842, 859 (Bankr. N. D. Ohio 1989), *aff'd*, 937 F.2d 1104 (6th Cir. 1991) ("[I]nconsistent state laws must give way to

SIPA, a federal statute.") Here, to the extent that any state law would provide a different form of relief for the customer than under SIPA, SIPA controls.

Second, the Official Comment to the UCC itself, expressly citing SIPA as an example, provides that SIPA overrides the UCC if the entity's affairs are being administered in an insolvency proceeding. *See* U.C.C. [Rev.] § 8-503, Official Comment 1 (2009) ("applicable insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ...."). *See also American Sur. Co. of N.Y. v. Sampsell*, 327 U.S. 269, 272 (1946) ("[F]ederal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to his creditors.").

B. Federal Securities Law

Like the provisions of the UCC, the federal securities law decisions cited by the Defendants do not apply. Effectively, Defendants' position that any antecedent debt must be based on the fictitious account statements issued to them would create an entitlement to fake profits where there is none. *See In re New Times Securities Services, Inc.*, 371 F.3d 68, 88 (2d Cir. 2004) (court will defer to persuasive analysis of "potential absurdities created by reliance on the entirely artificial numbers contained in fictitious account statements.") Moreover, their assertion that not measuring antecedent debt by the last account statement undermines SIPA's goal of customer protection is incorrect. Def. Mem. at 9-18.[9] See *Focht v. Athens* (*In re Old*

[9] Defendants' contend that SIPC urges a novel interpretation of SEC Rule 15c3-3. Def. Mem. at 14 n.6. To the contrary, the plain language of SEC Rule 15c3-3 requires that a broker-dealer maintain physical possession or control of customers' fully paid securities and excess margin securities, and establish a special reserve account for the exclusive benefit of customers. *See* 17 C.F.R. 240.15c3-3(b) and (e). The broker must keep sufficient assets in the account in relation to the fully paid securities and excess margin securities that it owes to customers. *Id.*

Naples Securities, Inc.), 311 B. R. 607, 616-617 (M. D. Fla. 2002) ("Especially where the payments to claimants will be made out of the quasi-public SIPA fund, permitting claimants to recover not only their initial capital investment but also the phony "interest" payments they received and rolled into another transaction is illogical." ... This result is not consistent with the goals of SIPA, which does not purport to make all victimized investors whole but only to partially ameliorate the losses of certain classes of investors. *See [SEC v. Packer Wilbur, & Co.,* 498 F.2d 978, 983 (2d Cir. 1974)"].

CONCLUSION

For all of the aforementioned reasons, the Defendants' Motion should be denied.

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Washington, D.C.

Respectfully submitted,

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