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

IRVING H. PICARD, Trustee for the Liquidation
of Bernard L. Madoff Investment Securities LLC,

Plaintiff,

v.

JAMES GREIFF, et al.¹

Defendant.

Case No. 11-cv-3775 (JSR)

**CLAWBACK DEFENDANTS' REPLY
MEMORANDUM OF LAW IN SUPPORT OF
MOTION TO WITHDRAW THE REFERENCE**

On the brief

Helen Davis Chaitman
Julie Gorchkova

¹ This motion is filed by Becker & Poliakoff LLP on behalf of 313 defendants in 108 clawback actions filed by Irving H. Picard, Trustee, as listed on Exhibit A to the June 2, 2011 Declaration of Helen Davis Chaitman.

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PRELIMINARY STATEMENT

The Trustee and SIPC ignore this Court's holding that a "substantial issue under SIPA is . . . , almost by definition, an issue 'the resolution of [which] requires consideration of both Title 11 and other laws of the United States.'" *Picard v. HSBC Bank PLC*, 2011 WL 1544494, at *2 (April 25, 2011) (quoting 28 U.S.C. § 157(d)) (hereinafter "*HSBC*"); see also *Picard v. JPMorgan Chase & Co., et al.*, 11 Civ. 0913, Slip Op. at 14.

Movants have raised three substantial issues under SIPA:

(i) Whether the Trustee has the power to utilize the avoidance provisions of the Bankruptcy Code (the "Code") under 15 U.S.C. § 78fff-2(c)(3), since he is holding \$3 billion more than he needs to satisfy all allowed customer claims.

(ii) Whether a SIPA trustee can claw back from defrauded customers of an SEC-regulated broker the withdrawals they took from their accounts, which simply reduced the broker's indebtedness to them.

(iii) Whether the Trustee has violated customers' due process rights under the United States Constitution because he receives a percentage of the fees generated by the 988 clawback actions he has instituted against innocent victims of Madoff's fraud.

The Trustee and SIPC ignore the fact that, on June 23, 2011, the Supreme Court issued *Stern v. Marshall*, 2011 WL 2472792 (hereinafter "*Stern*"), holding unconstitutional the Congressional delegation to the bankruptcy court of jurisdiction over "core" matters based on independent state law rights not necessary to determine a creditor's proof of claim. Clearly, the clawback actions fall within the category of cases described in *Stern* that require adjudication by an Article III judge. The clawback actions were not filed in order to resolve the SIPC claims filed by some, but not all, of the clawback de-

defendants and are not part of the claims resolution process. Yet, the Trustee does not even mention the *Stern* case; SIPC mis-states its holding.

The Trustee and SIPC ignore the fact that, on July 1, 2011, this Court withdrew the reference in *Picard v. Katz, et. al.*, Case No. 11-cv-3605 (S.D.N.Y. (JSR)), for determination of three separate issues advanced by the *Katz* defendants, two of which are identical to issues raised by Movants, *i.e.*, whether a fraudulent transfer claim can be stated where a creditor simply received payment on an antecedent debt and whether 11 U.S.C. § 546(e) bars the clawback actions. These issues require consideration of critical rights that Movants have under non-bankruptcy federal and state laws that are beyond the jurisdiction of an Article I judge.

Finally, the Trustee argues the merits of the issues raised by Movants, rather than addressing the question of whether withdrawal for consideration of the merits is mandated. With respect to Movants' argument that the clawback actions are barred by SIPA § 78fff-2(c)(3), the Trustee continues his deliberate obfuscation of material facts. On page 3 of his brief he states that "customers lost approximately \$20 billion." Yet, three pages later, the Trustee writes: ". . . the value of customer claims to be asserted against the Customer Fund remains unknown. It may rise as high as \$17.3 billion."² The Trus-

² Even the \$17.3 billion figure is inflated. The Trustee used the \$17.3 billion figure before he settled with Fairfield Sentry Limited ("Fairfield"). In a May 4, 2011 filing, the Trustee wrote that "the amount that the Trustee would have to recover in order to return 100% of the principal lost by those who are eligible to receive a distribution in this proceeding is approximately \$17.3 billion." Motion for Initial Distribution, Case No. 08-01789, Doc # 4048 at ¶ 6. Fairfield agreed to reduce its claim by \$962 million. See Proposed Settlement Agreement, Case No. 09-1239, Doc. #69 at ¶ ¶ 13, 22. The Fairfield settlement was approved on June 7, 2011. See Settlement Order, Case No. 09-1239, Doc. #92. Because of the bankruptcy court's order permitting the Trustee to settle claims without disclosure to the court, there may be further reductions of which Movants are unaware.

tee's lack of clarity about the threshold fact of the case is incredible given that he has spent over \$130 million on forensic accountants.³

The Trustee argues that the appeal of Judge Lifland's "net equity" decision to the Second Circuit precludes withdrawal of the reference, despite the fact that the clawback suits were filed long after Judge Lifland's decision on "net equity."

The Trustee argues that SIPC is not a quasi-governmental agency despite the fact that SIPC operates under the jurisdiction of the SEC and the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises. The Trustee argues that he is not a decision-maker despite the fact that the Trustee has been characterized as a decision-maker by SEC Chair, Mary Shapiro, and by SIPC's President, Stephen Harbeck.

I. *STERN V. MARSHALL* COMPELS WITHDRAWAL OF THE REFERENCE FOR THE CLAWBACK CASES IN THEIR ENTIRETY

In *Stern*, the Supreme Court ruled that § 157(b)(2) of the Code, which enumerates 16 examples of "core proceedings," is unconstitutional to the extent that it grants authority to a non-Article III judge to "enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." 2011 WL 2472792 at *27. In *Stern*, a creditor filed a proof of claim for defamation, thereby submitting to the bankruptcy court's jurisdiction with respect to the determination of his claim. He then filed a complaint against the debtor, alleging defamation and seeking to prevent the debtor's discharge. The debtor filed a counterclaim for tortious interference with contract. The bankruptcy court issued a judgment on the debtor's counter-

³ January 21, 2011 letter from SIPC President, Stephen Harbeck, to Congressman Scott Garrett at 21. A copy of the letter is annexed to the accompanying declaration of Helen Davis Chaitman (hereinafter the "Chaitman Reply Decl.") as Ex. A.

claim for tortious interference. The Supreme Court held that the counterclaim was “a state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in bankruptcy.” *Id.* at *16. It held that only an Article III judge could issue a final judgment on the counterclaim *despite* the fact that the litigation was part of a “core” proceeding and that the plaintiff had submitted to the bankruptcy court’s jurisdiction. *Id.* at *9-10, 27.

Here, while some of the Movants filed SIPC claims, the clawback suits were not filed as counterclaims to the SIPC claims. On the contrary, the Trustee simply rejected the SIPC claims and thereafter filed separate clawback actions raising critical rights under non-bankruptcy federal and state laws that are not within the jurisdiction of an Article I court. Thus, the Supreme Court’s decision compels the withdrawal of the reference of the clawback cases in their entirety.

The Trustee and SIPC argue that the Defendants “submitted” to the bankruptcy court’s jurisdiction. (Trustee Opp. at 16-17; *see also* SIPC Opp. at 16-17.) Numerous courts have recognized that the filing of a proof of claim does not waive the constitutional rights preserved by mandatory withdrawal. Accordingly, courts regularly withdraw the reference where parties have filed proofs of claim. *See, e.g., In re Dana Corp.*, 379 B.R. 448, 450-459 (S.D.N.Y. 2007) (withdrawal of reference mandatory even though movant submitted to bankruptcy court’s jurisdiction by filing proof of claim); *In re Adelphia Commc’ns Corp.*, No. 03 MDL 1529, 2006 WL 337667, *1, 3, 5 (S.D.N.Y. Feb. 10, 2006) (withdrawal of reference on mandatory and permissive grounds even though defendants submitted proofs of claim); *In re Enron Corp.*, 04 Civ. 8177, 2004 WL 2711101, *1, 4 (S.D.N.Y. Nov. 23, 2004) (withdrawal of reference mandatory even though defendants filed proofs of claim); *see also, e.g., In re Fairfield Communities*,

Inc., No. LR-M-91-160, 1992 WL 158642, *2 (E.D. Ark. Apr. 14, 1992) (withdrawal of reference *specifically to resolve* proof of claim; rejecting argument that submission to bankruptcy jurisdiction precluded mandatory withdrawal).

While SIPC notes that *Stern* distinguished between actions filed by creditors and non-creditors of the estate (SIPC Opp. at 16), that distinction is not determinative given the Court's ruling that it was unconstitutional to submit the claimant to the bankruptcy court's jurisdiction for purposes of adjudicating the debtor's counterclaim.

II. WITHDRAWAL OF THE REFERENCE IS MANDATORY AS TO THE SEMINAL ISSUES IN THE CLAWBACK CASES

As this Court held in *HSBC*, withdrawal of the reference is mandatory where there is a conflict between SIPA and bankruptcy law. *See also In re Cablevision*, 315 B.R. 818, 821 (S.D.N.Y. 2004) (“The very existence of a dispute as to whether the rights of [investors] under the [Trust Indenture Act] and Williams Act supersede Section 304 [of the Code] or whether the Code overrides the TIA, regardless of the ultimate resolution of such dispute, mandates withdrawal.”); *Bear Stearns Securities Corp. v. Gredd*, 2001 WL 840187, *2-4 (S.D.N.Y. July 25, 2001) (withdrawing reference where federal securities laws “arguably conflict[ed]” with the Code).

Here, Movants have raised seminal issues as to whether the Code conflicts with SIPA and the federal securities laws. Therefore, withdrawal is mandated.

1. Judge Lifland's “Net Equity” Decision Did Not Resolve the Antecedent Debt Defense

Both the Trustee and SIPC argue that withdrawal of the reference is barred because the antecedent debt defense was rejected by Judge Lifland in his “net equity” decision handed down before the clawback suits were filed. (Trustee Opp. at 15-16; SIPC Opp. at 19-20.) The issue decided by Judge Lifland and *sub judice* in the Second Circuit

is how to calculate a customer's claim under SIPA, which defines a customer's "net equity" as his last statement balance. 15 U.S.C. § 78III(11). Judge Lifland was very careful to state that he was reserving decision on all issues other than the SIPA definition of "net equity." *See Net Equity Decision*, Case No. 08-01789, Doc. #1999, at 24 n.30 (indicating that court was not going to reach merits of potential defenses to avoidance actions since none were yet commenced.)

The clawback suits seek to recover funds withdrawn from the customers' accounts in the six-year period before the liquidation was initiated, during a period of time when the broker's obligations were governed by Article 8 of the UCC and an array of federal securities laws, including Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under those laws, BLMIS was indebted to its customers for the securities listed on their brokerage statements and the customers were legally entitled to make withdrawals from their accounts. No provision of SIPA, or any other law, alters these fundamental obligations simply because a SIPA liquidation is commenced.

The Trustee's contention that he can self-effectuate fraudulent transfer judgments by netting out deposits and withdrawals going back to the 1960's and then, based on his calculations, sue investors for their withdrawals in excess of their net investments, was not directly addressed by Judge Lifland in his "net equity" decision (although, clearly, if a customer is entitled to his last statement balance, based on federal securities law, that would be an additional argument against the clawback suits).

2. Movants Have Raised the Issue of a Violation of Their Constitutional Rights

The Trustee, addressing the merits of the due process issue, argues that Movants are entitled only to notice and an opportunity to be heard. (Trustee Opp. at 17-19.)

However, the Trustee ignores the holdings in *Tumey v. Ohio*, 273 U.S. 510 (1927); *Aetna Life Ins. Co. v. Lavoie*, 475 U.S. 813 (1986); and *Caperton v. A.T. Massey Coal Co., Inc.*, 129 S. Ct. 2252 (2009), which recognize that it is a fundamental violation of due process for a quasi-governmental official to be enriched by decisions he makes. Moreover, in *Young v. United States*, 481 U.S. 787, 809-10 (1987), the Court held that an impermissibly biased prosecutor or other official is a *per se* violation of due process. *See also Marshall v. Jerrico*, 446 U.S. 238, 242-52 (1980) (same).

Addressing the merits, the Trustee argues that he is not a state actor because SIPC is not a quasi-governmental agency and he is not a decision-maker for SIPC. (Trustee Opp. 20.) However, these are disputed issues that must be decided by an Article III court. The Movants contend the Trustee is a quasi-governmental officer because he was selected by, is paid by, and works on behalf of, SIPC, which has been described as a “hybrid organization . . . with predominately private-sector legal characteristics, [created] to implement government policies and regulations.”⁴ “Although the SIPC is a nonprofit corporation under the D.C. law, it is effectively a subsidiary of the SEC.” *Id.* at 15. In essence, SIPC is an “agent[] of and accountable to the government through the SEC.” *Id.* at 16. As such, it is a quasi-governmental agency.⁵

⁴ Congressional Research Service, “The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics,” dated June 22, 2011, at 16.

⁵ Moreover, the Trustee’s assertion that he is not a decision-maker for SIPC is contradicted by his own conduct. The Trustee releases certain clawback defendants from liability if they demonstrate “hardship” to him on a “Hardship Application” posted on his website. The end of the Hardship Application warns the applicant that any false statement in the application is criminally punishable under 18 U.S.C. § 1001. (Chaitman Reply Decl. Ex. B, at 3.) It is a crime under 18 U.S.C. § 1001 to make a false statement “in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States.” (*Continued*)

3. The Conflict between SIPA and § 546(e) of the Code Requires Withdrawal

Section 546(e) of the Code provides that a “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 . . .” *Id.* Under § 546(e), a transfer by a broker to a customer may be avoided only if made within two years of a SIPA filing and only if there was an intentional fraudulent transfer under Code § 548(a)(1)(A). Plainly, if § 546(e) applies, the complaints must be dismissed because the Trustee concedes there was no fraudulent intent on the part of the defendants. Moreover, claims for withdrawals prior to December 11, 2006 would be void.

SIPC and the Trustee argued that § 546(e) is “altogether” inapplicable to this case on many grounds, including that BLMIS was not a “broker” for purposes of § 546(e) and that the application of § 546(e) is “incompatible with SIPA.”⁶ The Trustee’s and SIPC’s interpretation of SIPA is novel and conflicts with the Code, thereby compelling consideration by an Article III court.

On the merits of this issue, we note, first, that BLMIS was, and must have been, a broker because it is the subject of a SIPA proceeding. Only a registered broker qualifies as a candidate for a SIPA proceeding. *See* 15 U.S.C. § 78ccc(a)(2)(A) (defining SIPC members as registered brokers or dealers under the federal securities laws). If BLMIS

This statute does not apply to false statements made in private civil actions in federal court. *See CJS*, Fraud § 127 (2011). The Hardship Applications are sent to the Trustee, but they are not filed with the Court. Thus, if the Trustee was not a quasi-governmental officer, he would not (or should not) have invoked 18 U.S.C. § 1001 penalties.

⁶ *See e.g.* Trustee's Memorandum in Opposition to the Sterling Defendants' Motion to Dismiss . . . , Case No. 10-5287, Doc. #49, at 90-91; Memorandum of Law of the Securities Investor Protection Corporation in Opposition to Sterling Defendants' Motion to Dismiss . . . , Case No. 10-5287, Doc. #48, at 19-20.)

was a broker for purposes of the Trustee serving in a SIPA liquidation in which his law firm has been paid over \$180 million, BLMIS was a broker for purposes of § 546(e).

Second, while Judge Lifland has held that § 546(e) is “incompatible” with SIPA (*Picard v. Merkin*, 440 B.R. 243, 267-68 (Bankr. S.D.N.Y. 2010)), such a determination can only be made by an Article III judge. SIPA on its face permits use of the avoidance powers only “if and to the extent that [a] transfer is voidable or void under the provisions of title 11.” SIPA § 78fff-2(c)(3). Section 546(e) plainly limits the voidability of transfers under Title 11 and, therefore, on its face applies in a SIPA proceeding. The Trustee’s argument that § 546(e) is an impediment to his avoidance powers as a SIPA trustee is an issue on which withdrawal is mandatory.

4. The Interpretation of SIPA §78fff-2(c)(3) Must Be Made by an Article III Court

SIPA § 78fff-2(c)(3) allows a SIPA trustee to use the avoidance provisions of the Code **only** when there are insufficient funds in the fund of customer property to pay allowed customer claims (inclusive of the portion paid by SIPC insurance). The record demonstrates that the Trustee has \$3 billion more to distribute than claims he has allowed. While the Trustee may dispute this (despite his press releases to the contrary), the issue must be determined by an Article III court. *See HSBC; see also Picard v. JPMorgan Chase & Co., et. al.*, 11 Civ. 0913, Slip Op. at 14 (“[A]n issue that requires significant interpretation of SIPA undoubtedly requires consideration of laws other than Title 11.”).

The Trustee argues that, under *In re Bevill, Bresler & Schulman, Inc.*, 83 B.R. 880 (D. N.J. 1988), the fund of customer property must be valued on the SIPA filing

date. (Trustee Opp. at 12-14.) Again, the Trustee is arguing the merits of the issue as a ground for not withdrawing the reference.

CONCLUSION

For the reasons stated in Movants' initial memorandum and herein, Defendants respectfully request that the Court withdraw the reference of their adversary proceedings in their entirety.

July 18, 2011

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