

BECKER & POLIAKOFF LLP
Helen Davis Chaitman
45 Broadway, 8th Floor
New York, New York 10006
(212) 599-3322
HCHAITMAN@BECKERNY.COM

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*Attorneys for Customers Listed on Exhibit A
to the Chaitman Declaration*

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

IRVING H. PICARD,

Plaintiff,

v.

JAMES GREIFF *et al.*,

Defendants.

11-CIV-3775 (JSR)

**CUSTOMERS' MEMORANDUM OF LAW IN SUPPORT OF
MOTION TO DISMISS THE COMPLAINTS**

On the brief

Helen Davis Chaitman

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PRELIMINARY STATEMENT

Defendants (the “Customers”)¹ respectfully submit this memorandum in support of their motion to dismiss the complaint pursuant to Federal Bankruptcy Rule 7012(b)(6) and FRCP 12(b)(6) for failure to state a claim upon which relief can be granted.

Irving H. Picard, as Trustee of Bernard L. Madoff Investment Securities LLC (“BLMIS”), filed close to 1,000 separate actions against approximately 5,000 innocent investors (including 313 Customers) alleging that they had received fraudulent transfers from BLMIS. In each complaint, the first claim is brought under 11 U.S.C. § 548(a)(1)(A); the second claim is brought under 11 U.S.C. § 548(a)(1)(B); and the remaining claims are brought under New York Debtor and Creditor Law. In *Picard v. Katz, et al.* (“*Katz*”), this Court held that the Trustee’s avoidance powers are limited by 11 U.S.C. § 546(e) to actions under 11 U.S.C. § 548(a)(1)(A). (Chaitman Decl. Ex. B, *Katz* Memorandum and Opinion, Case No. 11-03605 (S.D.N.Y.), Doc. # 40, at 4.)

We, therefore, address two issues: (1) whether the Trustee has stated a claim under § 548(a)(1)(A) against the Customers; and (2) if so, what is the correct method for determining a Customer’s liability for withdrawals post-dating December 11, 2006.

¹ This motion was filed on behalf of 313 defendants in 108 separate actions as listed on Exhibit A to the 10/5/2011 Declaration of Helen Davis Chaitman (“Chaitman Decl.”). In all of the actions the Trustee makes the identical substantive allegations. At oral argument, the Court properly pointed out that we had not filed 108 motions, one in each of the separate actions. However, as a practical matter, a holding in the Greiff action will be applicable to all of the other actions and we defer to the Court as to the most efficient way to accomplish this result.

SUMMARY OF ARGUMENT

A. Fraudulent Transfer

Section 548(a)(1)(A) provides that a “trustee may avoid any transfer **of an interest of the debtor** in property . . . on or within 2 years before the date of filing of the petition, if the debtor . . . made such transfer with actual intent to hinder, delay or defraud.” (Emphasis added.) However, a transferee who takes for value and in good faith may retain any interest transferred regardless of a debtor’s intent pursuant to the affirmative defense provided under 11 U.S.C. §548(c).

As to the first element of his claim, the Trustee cannot establish that the debtor, BLMIS, had an interest in the Customer withdrawals. On the contrary, BLMIS stole the funds that were used to pay Customers. It is black letter law that a thief does not take title to stolen property and, hence, has no interest in such property. Thus, BLMIS had no interest in the funds transferred to Customers and the Trustee has no standing to recover them. *See, e.g., Daly v. Kennedy (In re Kennedy)*, 279 B.R. 455, 460 (Bankr. D. Conn. 2002) (“A thief does not acquire good title to the property he steals . . .”); *Congress Financial Corp. v. Levitan (In re Levitan)*, 46 B.R. 380, 387 (Bankr. E.D.N.Y. 1985) (holding that alleged embezzler cannot have any interest in stolen funds).

As to the second element, this Court held in *Katz* that the transfers to Customers were made by BLMIS with actual intent to hinder, delay or defraud. And for purposes of the motion to dismiss, the Customers acknowledge that the complaint makes this allegation. Ultimately, however, the Trustee will not be able to prove this allegation because BLMIS was not a Ponzi scheme and because the transfers were initiated by the Customers, not by BLMIS.

As to the first prong of the section 548(c) affirmative defense, it is indisputable that the Customers took “for value” because they were creditors of BLMIS and the payments to them simply reduced BLMIS’ debt to them. The Second Circuit acknowledged this proposition when it held that the Customers were creditors of BLMIS with valid claims. *See In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3568936, 6 (2d Cir. August 16, 2011). Thus, the transfers received by the Customers, *i.e.*, their withdrawals, were made in partial satisfaction of an antecedent debt owed to them by BLMIS under their contracts with BLMIS, under Article 8 of the Uniform Commercial Code (the “UCC”) and under the federal securities laws. *See, generally*, NYUCC § 8-501 *et seq*; 17 C.F.R. § 240.10b-10; NASD Rule 2340; NYSE Rule 409. As a matter of law, then, the transfers to Customers were received in exchange “for value.”

As to the second prong of the affirmative defense in section 548(c), *i.e.*, whether the Customers acted in good faith, this is the issue that the court in *Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Investment Fund Ltd.)*, 397 B.R. 1 (S.D.N.Y. 2007) (“*Manhattan*”), remanded for trial. The *Manhattan* court held that, as a matter of law, the transfers at issue were made by a Ponzi schemer and thus were made with intent to defraud. However, as to the first prong of the affirmative defense, the court held that there was “no dispute that Bear Stearns took the transfers for value,” (*id.* at 20), even though the transfers to it were “related to the [Ponzi] scheme” (*id.* at 11), because the transfers were in satisfaction of a contractual obligation. As to whether Bear Stearns satisfied the second prong of the affirmative defense, *i.e.*, good faith, the court held that Bear Stearns was entitled to a trial:

. . . there are genuine issues of material fact as to whether the proactive steps taken by Bear Stearns demonstrated diligence in

its investigation of the Fund. Thus, trial will be necessary on this issue.

Id. at 22.

Here, unlike the situation in *Manhattan*, and unlike the Trustee's complaint in the *Katz* case, the Trustee does not contend that the Customers acted in bad faith or with a lack of due diligence. (Chaitman Decl. ¶ 2.) Hence, it is appropriate to dismiss the complaints as a matter of law pursuant to the affirmative defense of §548(c) because they gave value in reducing the amount of their contractual claim against BLMIS each time they took a withdrawal.

B. The *Katz* Footnote 6 Issue

If the Court determines that the transfers are avoidable, the proper calculation, required by 11 U.S.C. §§ 546(e) and 548(c), is to acknowledge as valid the December 11, 2006, statement balance of each Customer and then, considering only the withdrawals of earnings in the last two years, credit against the Customer's withdrawals of earnings any deposits the Customer made within the last two years.

STATEMENT OF FACTS

The Trustee has sued the Customers in substantially identical actions to recover withdrawals that they took from their BLMIS accounts in the ordinary course of their financial affairs. (Chaitman Decl. ¶ 1.) The Trustee calculates each Customer's liability based upon funds they (or their parents or grandparents) withdrew over a period extending through generations as far back as the 1960's. The Trustee claims that each Customer has an obligation to return the amount by which the Customer's withdrawals exceeded his deposits over a 50-year period. (*Id.*)

ARGUMENT

I. THE CUSTOMER WITHDRAWALS WERE NOT TRANSFERS OF “AN INTEREST OF THE DEBTOR IN PROPERTY” AND, HENCE, ARE NOT AVOIDABLE UNDER 11 U.S.C. §548(A)(1)(A)

The Trustee’s avoidance powers are limited to transfers of “an interest of the debtor in property.” *See* 11 U.S.C. § 548(a)(1). The funds deposited by Customers into their accounts belonged to the Customers at all times, not to BLMIS. Therefore, any claims to recover the amounts deposited by Customers and stolen by Madoff belong to the Customers and not to the Trustee. BLMIS never acquired an “interest” in the Customers’ funds because, although the funds were entrusted to BLMIS, Madoff stole them. *See, e.g., United States v. Benitez*, 779 F.2d 135 (2d Cir. 1985) (citing *United States v. Central National Bank of Cleveland*, 429 F.2d 5 (8th Cir. 1970) (holding that robber had no legal interest in stolen money)). Therefore, under the well-settled principle that a thief **never** acquires title to stolen property, the transfers fall outside the Trustee’s avoidance powers.

A bankruptcy trustee’s standing has been carefully limited by Congress. In *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir. 1994), Judge Posner, writing for the Seventh Circuit, held that a trustee lacked standing to sue on behalf of creditors .

When a third party has injured not the bankrupt corporation itself but a creditor of that corporation, the trustee in bankruptcy cannot bring suit against the third party. He has no interest in the suit. The claim in such a case is said to be “personal,” not “general.” [citation omitted.] That is not an illuminating usage. The point is simply that the trustee is confined to enforcing entitlements of the corporation. He has no right to enforce entitlements of a creditor. He represents the unsecured creditors of the corporation; and in that sense when he is suing on behalf of the corporation he is really suing on behalf of the creditors of the corporation. But there is a difference between a creditor’s interest in the claims of the corporation against a third party, which are enforced by the

trustee, and the creditor's own direct – not derivative – claim against the third party, which only the creditor himself can enforce.

In *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 434 (1972), the Supreme Court held that a Chapter X trustee had no standing under the Bankruptcy Act to assert claims of misconduct against a third party on behalf of the debtor's debenture holders because the Bankruptcy Act did not authorize a trustee "to collect money not owed to the estate and because the debtor had no claim against the indenture trustee but, instead, was *in pari delicto* with the indenture trustee. *Id.* at 428-30. When the Bankruptcy Code was being drafted in 1977, a provision was inserted into a draft of Section 544 that would have given a trustee the power to enforce a claim that any individual creditor or class of creditors had against a third party. The proposed provision was intended to overrule *Caplin*. See H.R. Rep. No. 95-595, 95th Cong. 1st Sess. 370-71 (1977). The Eighth Circuit explained this history as follows:

As originally proposed by the House, Section 544 was to contain a subsection (c), which was intended to overrule *Caplin*. **It is extremely noteworthy, however, that this provision was deleted before promulgation of the final version of Section 544.** Because subsection (c), as a part of Section 544, would have applied to both reorganization and liquidation trustees, and because Congress refused to enact subsection (c), we believe Congress' message is clear--no trustee, whether a reorganization trustee as in *Caplin* or a liquidation trustee as in the present case, has power under Section 544 of the Code to assert general causes of action, such as the alter ego claim, on behalf of the bankrupt estate's creditors.

In re Ozark Restaurant Equipment Co. Inc., 816 F.2d 1222 (8th Cir. 1987) (emphasis added); accord *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988); *In re Adam Furniture Industries, Inc.*, 191 B.R. 249 (Bankr. S.D. Ga. 1996); see also Gerald K.

Smith, “Avoiding Powers of Trustee,” in *Practicing Under the Bankruptcy Reform Act 113* (Hon. George Brody et al eds., CRR Publishing Co. 1977).

The Customers’ funds do not become property of the estate simply because Madoff held them in trust as a custodian or had some equitable title or interest in those funds. *See Begier v. I.R.S.*, 496 U.S. 53 (1990) (holding that debtor’s payment of taxes collected from customers were not transfers of “property of the debtor,” but were instead transfers of the customers’ property held in trust); *In re Schick*, 246 B.R. 41, 44-45 (Bankr. S.D.N.Y. 2000) (recognizing that “[t]he equitable title or interest is neither “property of the estate” under section 541 nor “property of the debtor” under section 547(b)”).

Each of the Trustee’s complaints recites that he is relying on Section 544 for standing to bring suit. He has no such standing. If the Customers had purchased **equity** interests in BLMIS and given Madoff control over their funds as investors, then, arguably, BLMIS might have had an **interest** in the funds that were invested. *See, e.g., In re M & L Business Mach. Co.*, 160 B.R. 851, 856-57 (Bankr. D. Colo. 1993) (dishonest debtor who obtained funds through equity investors in debtor acquired an “interest” in funds for purposes of 11 USC § 548). Here, however, BLMIS never acquired an interest in the Customers’ funds because BLMIS held them as a fiduciary of the Customers. The Customers’ funds belonged to the Customers, not BLMIS. Therefore, the Trustee lacks standing to sue under § 548(a)(1)(A).

The Trustee will undoubtedly rely upon SIPA §78fff–1(a) which provides that a “[SIPA] trustee shall be vested with the same powers and title with respect to the debtor and property of the debtor, **including the same right to avoid preferences**, as a trustee in a case under Title 11.” (Emphasis added.) The Trustee will also rely upon *In*

re Park South Securities, LLC, 326 B.R. 505, 512-13 (Bankr. S.D.N.Y. 2005), which construed the above provision as authorizing a SIPA trustee to assert fraudulent transfer claims. However, Congress did not include the right to bring fraudulent transfer actions in 15 U.S.C. § 78fff-1(a) and we have no reason to believe this omission was an accident. Thus, we believe this provision was intended solely to allow a SIPA trustee to bring preference actions (impermissible, in any event, under 546(e)).

II. THE TRANSFERS WERE NOT MADE WITH INTENT TO DEFRAUD

Courts employ the “Ponzi scheme presumption” in holding that transfers made by a Ponzi schemer are, as a matter of law, made with intent to hinder, delay and defraud creditors. *See Manhattan*, 397 B.R. at 12 (holding that if Ponzi scheme presumption applies, “actual intent” for purposes of section 548(a)(1)(A) is established as a matter of law); *see also In re 1031 Tax Group LLC*, 439 B.R. 47, 72 (Bankr. S.D.N.Y. 2010) (same), *In re Dreier LLP*, 452 B.R. 391, 424 (Bankr. S.D.N.Y. 2011) (“Courts have uniformly recognized a presumption of actual intent to defraud on the part of the transferor in the context of a Ponzi scheme.”). However, not every transfer made by a Ponzi schemer is intentionally fraudulent. Certainly, a Ponzi schemer does not fraudulently transfer funds when he pays his landlord, his phone bill, or his taxes; that is, when he pays his **creditors**.

A careful examination of the fraudulent transfer cases arising out of Ponzi schemes demonstrates that the only successful fraudulent transfer actions by trustees of Ponzi schemes are cases brought against **investors** in the Ponzi scheme. The theory of these cases is that a Ponzi scheme is a non-existent business in which investors purchase **equity** interests where “monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors.” *United States*

v. Silvestri, 409 F. 3d 1311, 1317 n. 6 (11th Cir. 2005) (citations and internal quotations omitted) (emphasis added); *Eberhard v. Marcu*, 530 F.3d 122, 132 n.7 (2d Cir. 2008) (“A ‘Ponzi scheme’ typically describes a pyramid scheme where earlier **investors** are paid from the investments of more recent investors, rather than from any underlying business concern, until the scheme ceases to attract new investors and the pyramid collapses”) (citing *Orlick v. Kozyak (In re Fin. Federated Title & Trust, Inc.)*, 309 F.3d 1325, 1327 n.2 (11th Cir. 2002) (emphasis added); *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1331 n.1 (10th Cir. 1996) (same) (emphasis added).

Here, the Customers were not equity investors in BLMIS any more than a person whose IRA is managed by J.P. Morgan Chase (“Chase”) is an equity investor in Chase. Bernard L. Madoff was the only member of BLMIS. The Customers had no equity interest in BLMIS. The Customers had a debtor-creditor relationship with BLMIS in precisely the same way that a depositor has a debtor-creditor relationship with his bank. *See U.S. v. Manufacturers Trust Co.*, 198 F.2d 366, 367 (2d Cir. 1952) (“The relationship between the bank and its depositor is that of debtor and creditor.”) (citation omitted).

Moreover, BLMIS was **not** a “Ponzi” scheme, despite the fact that the Trustee so labels it. BLMIS was far from a non-existent business. To the contrary, it was, perhaps, the largest single trader in securities in the world. BLMIS employed 200 people, 94% of whom conducted trades equal to 10% of the daily volume on the New York Stock Exchange for customers like Bear Stearns, Schwab, and Fidelity. *See Randall Smith, Wall Street Mystery Features a Big Board Rival*, THE WALL STREET JOURNAL, Dec. 16, 1992. As stated by one commentator:

In 2008, BMIS had \$700 million of equity capital and handled approximately 10% of the NYSE trading volume. Its 200 employees (100 people in trading, fifty in technology, and fifty in the back office) were divided between New York and London, but only twelve of them were assigned to the famous split-strike conversion strategy devised by Madoff.²

Thus, BLMIS was a legitimate trading business which simply operated a fraudulent investment business on the side to fund the trading operation. The fact that Customers were defrauded does not make BLMIS a Ponzi scheme.

Finally, the smoking gun in this case is the fact that investors' money was used to purchase securities in BLMIS' legitimate trading operation. The Trustee's own expert has admitted that investors' money was deposited "directly and indirectly" into the BLMIS trading accounts.³ While the Trustee has refused to produce BLMIS' trading and bank records on grounds of attorney/client and work product privileges (!),⁴ ultimately, through these records, Customers will demonstrate the extent to which their funds financed BLMIS' legitimate trading operations. Indeed, the records may show that investors' money was used to purchase the very securities shown on their confirmations and monthly statements.

² Greg N. Gregoriou and Francois-Serge Lhabitant, *Madoff: A Riot of Red Flags*, Jan. 2009, p. 7, available at

http://faculty-research.edhec.com/jsp/fiche_document.jsp?CODE=1234770344525&LANGUE=1

³ See Chaitman Decl. Ex. C, Decl. of Joseph Looby in Support of Trustee's Motion for an Order Upholding Trustee's Determination . . . of Net Equity, Case No. 08-01789 (Bankr. S.D.N.Y.), Doc. # 524, at ¶¶ 9, 17, 18, 19, 26, 27.

⁴ See Chaitman Decl. Ex. D, Trustee's Opposition to BLMIS Customers' Motion to Compel the Trustee to Provide a Report of His Investigative Activities and the Financial Affairs of BLMIS, Case No. 08-01789 (Bankr. S.D.N.Y.), Doc. # 4147.

III. THE CUSTOMERS TOOK FOR VALUE

Regardless of whether a transfer is made by a Ponzi schemer, if the payment was made in satisfaction of an antecedent debt, such as BLMIS' debt to the Customers, it is a transfer "for value" and constitutes one of the two prongs of the affirmative defense under 11 U.S.C. § 548(c). The proposition that each Customer was a creditor of BLMIS was recognized by the Second Circuit in *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3568936, 6 (2d Cir. August 16, 2011) ("We conclude that BLMIS claimants are customers with claims for securities within the meaning of SIPA."). Moreover, the Trustee conceded that Customers are creditors when he acknowledged that all "BLMIS customers who filed claims—whether their net equity customer claims were allowed or denied—are general creditors of the BLMIS estate." Trustee's Fifth Interim Report ¶ 76, *In re Madoff*, No. 08-01789, doc. # 4072 (Bankr. S.D.N.Y. May 16, 2011).

Each transfer from BLMIS to a Customer reduced the Customer's account balance dollar-for-dollar. Thus, even if the withdrawals resulted in one Customer being paid while another was not, the withdrawals cannot be recovered under § 548(a)(1)(A). See *In re Sharp International Corp.*, 403 F.3d 43, 54 (2d Cir. 2005) (quoting *Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.*, 191 A.D.2d 86, 90-91, 599 N.Y.S.2d 816 (1st Dep't 1993)) (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").

Judge Lifland recognized that a payment to a creditor by a Ponzi schemer is not a fraudulent transfer. In *In re Bernard L. Madoff Inv. Securities, LLC*, Judge Lifland cited *In re Unified Commercial Capital, Inc.*, 260 B.R. 343, 351 (Bankr. W.D.N.Y. 2001), for the proposition that it is a

universally accepted fundamental commercial principal that, when you loan an entity money for a period of time in **good faith**, you have **given value and are entitled to a reasonable return**.

440 B.R. 243, 262 (Bankr. S.D.N.Y. 2010) (emphasis added).

“Value” is determined as of the date of the transfer; subsequent appreciation or depreciation is irrelevant. *See In re Morris Communications NC, Inc.*, 914 F.2d 458, 466 (4th Cir. 1990) (discussing “reasonably equivalent value” under Section 548 and finding that “[t]he critical time is when the transfer is ‘made’.” Neither subsequent depreciation nor appreciation affects the question of whether reasonably equivalent value was given.).

Here, on the date of each transfer, the Customers had a valid claim against BLMIS for the amount stated on their account statements pursuant to their contracts with BLMIS and Article 8 of the UCC. *See infra*. Therefore, the transfers were “for value” and are not avoidable by the Trustee. This is consistent with the purpose of the fraudulent transfer laws which is to ensure that a **debtor** does not “unfairly drain[] the pool of assets available to satisfy creditors’ claims.” 5 *Collier on Bankruptcy* § 548.01 [1][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010). Here, the transfers were initiated by **the Customers**, not by the debtor. BLMIS simply complied with the instructions of the Customers to partially liquidate positions in their accounts. The fact that this resulted in preferential treatment for them is irrelevant. *See In re Sharp*, 403 F.3d 43,54 (2d Cir. 2005):

[E]ven the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because “[t]he 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.”

Id. (quoting *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995)).

Sharp is directly on point on the first prong of the section 548(c) affirmative defense because it demonstrates that value can be established through creditor status. Whether a debtor is perpetrating a fraud, as in *Sharp*, or a Ponzi scheme, as alleged here, a **creditor** who acts in good faith and simply demands payment of a contractual obligation is not liable for an intentional fraudulent transfer. Obviously, even a Ponzi schemer has real creditors, such as the Customers. It is only transfers to **equity investors** by a Ponzi schemer that do not constitute value pursuant to §548(c).

Thus, even where the “transfers sought to be avoided are related to the [Ponzi] scheme,” (*Manhattan*, 397 B.R. at 11), they cannot be avoided if the two prongs of the affirmative defense are satisfied. In fact, in *Manhattan*, even though the court accepted the “Ponzi scheme presumption” for purposes of establishing the debtor’s intent, the court found that Bear Stearns had given value because it was a valid creditor of the debtor and the court remanded for a trial on the issue of Bear Stearns’ good faith. *Id.* at 11-12.

For these reasons, the “Ponzi” scheme line of cases with which the Trustee is so enthralled cannot save his complaints against innocent Customers. This proposition was recognized in *In re Bayou Group, LLC*, 439 B.R. 284, 337 (Bankr. S.D.N.Y. 2010), a case involving a true Ponzi scheme, where Judge Gardephe distinguished equity investors in the Ponzi scheme from creditors whose claims were grounded in contract and had “contractually guaranteed rates of return” (citing *In re Carrozzella & Richardson*, 286 B.R. 480, 484–91 (Bankr. D. Conn. 2002) (contractual interest rates constituted reasonably equivalent value for use of money, defeating fraudulent transfer claim) and

Lustig v. Weisz & Assocs. (In re Unified Commercial Capital), 2002 WL 32500567, 8 (W.D.N.Y. June 21, 2002) (“the payments to [the defendant] were not simply payments of nonexistent profits, but of a contractually provided-for, commercially reasonable rate of interest on what amounted to a loan”).

In sum, it is only a Ponzi schemer’s payments to equity holders in the Ponzi scheme entity that are lacking in “value” under §548(c), as the court explained in *Kapila v. Integra Bank (In re Pearlman)*, 440 B.R. 569 (Bankr. M.D. Fla. 2010). There, in the liquidation of a real Ponzi scheme, the trustee sought to void as fraudulent transfers loans that banks had made to the Ponzi schemer. The court held that “bank loans are by any definition **not** investments”:

The trustee’s insistence that these bank loans should be considered investments ignores the many real differences between the two concepts, **most notably the contractual interest rate on loans versus the unknown risk premium of equity investments.**

Id. at 575 (emphasis added).

If BLMIS had refused to honor a transfer request from a Customer, the Customer could have marched into New York Supreme Court and obtained a judgment against BLMIS for his statement balance. If, on the other hand, a Customer was simply an equity investor in BLMIS, he would have had no right to force BLMIS to pay him a certain sum of money because there was no debt.

Here, the Customers, **by contract and by law**, were entitled to the balances shown on their statements. Indeed, even under the Securities Act of 1933, 15 U.S.C. 77l, the Customers are entitled to interest on their stolen funds. Section 77l(a)(2) permits defrauded customers “to recover the consideration paid for such security **with interest** thereon, less the amount of income received thereon . . . “ (Emphasis added.) Hence,

there can be no dispute that the Customers have satisfied the first prong of the section 548(c) affirmative defense.

IV. THE CUSTOMERS ACTED IN GOOD FAITH

The Customers have satisfied the second prong of the section 548(c) affirmative defense as well. In *HBE Leasing*, the Second Circuit held that “where . . . a transferee has given equivalent value in exchange for the debtor’s property, the statutory requirement of ‘good faith’ is satisfied if the transferee acted without either actual or constructive knowledge of any fraudulent scheme.” 48 F. 3d at 636. Similarly, in *Sharp*, the Second Circuit held that a creditor can establish the good faith prong of the affirmative defense even where the creditor knew that the debtor defrauded investors in order to raise the money to pay the creditor:

[t]o find a lack of “good faith” where the transferee does not participate in, but only knows that the debtor created the other debt through some form of [] dishonesty is to void the transaction because it amounts to a kind of “preference”-concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless.

Id. at 55 (quoting *Boston Trading Group, Inc. v. Burnazos*, 835 F.2d 1504, 1512 (1st Cir. 1987)).

Here, there is no allegation by the Trustee that the Customers participated in BLMIS’ fraud or that they had any knowledge of it prior to Madoff’s confession. Thus, there is no issue as to their good faith. The fact that the Customers withdrew a higher percentage of their account balances than other investors does not make the withdrawals voidable. It is only if the Customers acted in bad faith that they could not meet the

second prong of the affirmative defense. Hence, that issue is conceded and compels the dismissal of the complaints.

A. The Validity of the Customers' Debt Cannot Be Disputed

Article 8 of the UCC governs the relationship between BLMIS and the Customers. In recognition of the modern securities holding system, in which customers do not hold physical certificates, Article 8 provides that a broker's obligation to a customer is created by the issuance of a statement. When a customer entrusts funds to a broker for the purpose of buying securities and his broker issues a statement reflecting the purchase of the securities, the broker becomes obligated to the customer for those securities, whether or not the broker actually purchases them. *See* NYUCC § 8-501(c) (“[A] person has a security entitlement even though the securities intermediary does not itself hold the financial asset.”); *see also*, *Visconsi v. Lehman Bros.*, 244 Fed. Appx. 708, 713-14 (6th Cir. 2007) (“[T]he fictitious statements issued by Lehman, which were designed to track Plaintiffs’ funds as if they had been properly invested, indicate that Plaintiffs’ accounts would have grown to more than \$37.9 million . . . Plaintiffs thus . . . were entitled to the full \$37.9 million balance shown, regardless of the amounts of their previous deposits and withdrawals.)

As explained in the Official Comment to NYUCC § 8-501(c):

In the indirect holding system, the significant fact is that the securities intermediary has undertaken to treat the customer as entitled to the financial asset. It is up to the securities intermediary to take the necessary steps to ensure that it will be able to perform its undertaking.

* * * *

The entitlement holder's rights against the securities intermediary do not depend on whether or when the securities intermediary acquired its interests.

NYUCC § 8-501 cmt. 3.

Thus, the Customers were creditors of BLMIS entitled, contractually and by law, to the securities listed on their statements. Any transfers to them from BLMIS which reduced the balance in their accounts cannot be recovered under §548(a)(1)(A).

V. IF THE AVOIDANCE ACTIONS ARE NOT DISMISSED, CUSTOMERS ARE ENTITLED TO A CREDIT FOR DEPOSITS MADE AFTER DECEMBER 11, 2006

In footnote 6 of *Katz*, the Court deferred decision on how a Customer's liability for withdrawals during the two year period ending December 11, 2008 would be determined. We believe there is only one answer to this question: Consistent with the bar in §546(e) of any avoidance action which seeks to recover transfers made more than two years before the date of the filing, the Court must credit the Customer with his December 11, 2006 statement balance. Similarly, §548 "expressly prohibits [a trustee] from asserting a claim if the transaction occurred more than [two] years before the filing." *In re O.P.M. Leasing Services, Inc.*, 32 B.R. 199, 201 (Bankr. S.D.N.Y. 1983). Courts have uniformly enforced this statute of limitations. *See, e.g., Warfield v. Alaniz*, 453 F. Supp. 2d 1118, 1131 (D. Ariz. 2006), *aff'd* 569 F.3d 1015 (9th Cir. 2009); *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1145-46 (C.D. Cal. 2003); *In re Independent Clearing House Co.*, 77 B.R. 843, 887 (D. Utah 1987). Unless the Customer balance as of December 11, 2006 is accepted, the Trustee would be doing indirectly what the statute prohibits him from doing directly.

Any withdrawals after December 11, 2006 would be recoverable except to the extent that the Customer made any deposits during the two-year period. Under §548(c), any such deposits must be credited against the withdrawals to reduce the Customer's liability. Section 548(c) provides in relevant part:

(c). . . a transferee . . . that takes for value and in good faith has a lien on or may retain any interest transferred . . . as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer . . . (emphasis added.)

Thus, the appropriate formula is: Withdrawals during the period from December 12, 2006 through December 11, 2008, **less** deposits from December 12, 2006 through December 11, 2008. In other words, if the only activity in the two-year period were that a Customer withdrew \$100,000 on January 2, 2007, but invested \$100,000 on February 2, 2007, the Customer would have no liability. Under no circumstances should the Trustee be able to recover from any Customer for withdrawals prior to December 11, 2006.

CONCLUSION

For the reasons stated herein, the Customers respectfully request that the Court dismiss the Complaints in their entirety.

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BECKER & POLIAKOFF LLP

By: /s/ Helen Davis Chaitman

45 Broadway
New York, NY 10006
(212) 599-3322
HCHAITMAN@BECKERNY.COM
Attorneys for Defendants