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

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| In re:<br><br>BERNARD L. MADOFF INVESTMENT SECURITIES LLC,<br>Debtor, | Adv. Pro. No. 08-01789 (BRL)<br><br>SIPA LIQUIDATION<br><br>(Substantively Consolidated) |
| IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC,<br><br>Plaintiff,<br>v.<br><br>SAUL B. KATZ, et al.,<br><br>Defendants. | Adv. Pro. No. 10-05287 (BRL)<br><br>11 Civ. 03605 (JSR) (HBP) |

**TRUSTEE'S MEMORANDUM OF LAW IN SUPPORT OF**
**MOTION FOR PARTIAL SUMMARY JUDGMENT**

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

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

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Irving H. Picard ("Trustee"), trustee for the substantively consolidated liquidation of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa *et seq.*, and the estate of Bernard L. Madoff ("Madoff"), by and through his undersigned counsel, respectfully submits this memorandum of law in support of the Trustee's motion for partial summary judgment ("Motion") under Rule 56 of the Federal Rules of Civil Procedure to avoid and recover as fraudulent transfers the amounts transferred to the Two-Year Net Winner Defendants[1] by BLMIS for which such Defendants failed to provide value (i.e., fictitious profits) sought in Count One of the Trustee's Amended Complaint.[2]

## PRELIMINARY STATEMENT

BLMIS collapsed on December 11, 2008 when Bernard Madoff admitted that BLMIS's investment advisory business was a fraud. As the world now knows, Madoff took billions of dollars from customers and, instead of investing in securities and treasury bonds as he claimed,

[1] The "Two-Year Net Winner Defendants" are accountholders and/or transferees of transfers of fictitious profits made from 34 BLMIS customer accounts within two years of December 11, 2008 (the "Two-Year Period"). (Summary of Two-Year Transfers from BLMIS to Defendants in Excess of Principal attached as Ex. 2 to the Declaration of Matthew B. Greenblatt in Support of Trustee's Motion for Partial Summary Judgment ("Greenblatt Decl.").)

[2] The Trustee has sued the Sterling Defendants for all fictitious profits received over the life of their investment with BLMIS's investment advisory business, together with all transfers they received within the six years preceding December 11, 2008 (the "Filing Date"). However, the Court has ruled that the Trustee's claims are limited to the Two-Year Period. The Trustee has been denied leave to seek immediate appeal of that ruling and, therefore, limits this motion to the Two-Year Period. This motion does not seek summary judgment as to transfers made by BLMIS to the Sterling Defendants during the Two-Year Period that are equivalent to the amount of principal invested in those accounts because the recovery of these transfers raises numerous material and disputed facts more appropriately resolved at trial. *Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.),* 397 B.R. 1, 22 (S.D.N.Y. 2007) ("*Gredd V*") (reversing bankruptcy court grant of summary judgment on trustee's claim for principal because it was a jury question "whether Bear Stearns was diligent in its investigation . . . .").

deposited the cash into a bank account at JPMorgan Chase (the "703 Account"). From there, the customer money in the 703 Account was withdrawn to pay Madoff family members and other insiders, fund other BLMIS business units, including Madoff's proprietary trading and market making businesses, and fulfill the redemption requests of its investment advisory customers.

The scheme finally collapsed in 2008 when BLMIS ran out of money to fulfill the redemption requests of investment advisory customers, and Madoff turned himself in. In March 2009, Madoff pleaded guilty to several federal fraud charges. Charges against ten employees of the investment advisory business followed, and five have pleaded guilty thus far.

Thousands of BLMIS investment advisory customers lost billions of dollars they invested with Madoff. Other customers benefitted by receiving fictitious "profits" from Madoff's scheme—"profits" that in fact consisted entirely of funds deposited by other customers. The Sterling Defendants, who collectively received more than $295 million of fictitious profits over the course of their relationship with BLMIS, are among those who benefitted the most.

The Second Circuit has ruled that, in this case, "cash in/cash out" is the only fair method for calculating a customer's claim against the estate; a customer who withdrew less money than she put in, or a "net loser," has "net equity" in that account for purposes of a SIPA claim. Applying this method, the Trustee has determined each account's cash investment balance as of the date of each transfer. The same calculation identifies which investment advisory customers received fictitious profits, or are "net winners" from the Ponzi scheme. For this reason courts apply the "cash in/cash out" method to calculate fictitious profits in Ponzi scheme contexts.

Within the Two-Year Period, the Two Year Net Winner Defendants withdrew transfers of $83,309,162 in fictitious profits from 34 investment advisory accounts.

As this Court recognized, "[s]ince it is undisputed that Madoff's Ponzi scheme began more than two years before the filing of the bankruptcy petition and continued to almost the very day of filing, it is patent that all of Madoff Securities' transfers during the two-year period were made with actual intent to defraud present and future creditors, *i.e.*, those left holding the bag when the scheme was uncovered." *Picard v. Katz*, --- B.R. ---, 2011 WL 4448638, at *3 (S.D.N.Y. Sept. 27, 2011). Thus, "transfers made by Madoff Securities to its customers in excess of the customers' principal—that is, the customers' profits—…were in excess of the 'extent' to which the customers gave value, and hence, if adequately proven, may be recovered regardless of the customers' good faith." *Id*. at *4. Based on the facts as alleged in the Trustee's Amended Complaint, the Court noted that the Two-Year Net Winner Defendants would have difficulty "establishing that they took their net profits for value." *Id.* at *4, n.6.

Now, the relevant discovery has been completed and the record is clear. There is no genuine dispute that BLMIS made more than one and one half billion dollars in transfers to the Sterling Defendants with actual intent to defraud BLMIS's creditors. There is no genuine dispute that each of the Two-Year Net Winner Defendants received transfers of fictitious profits from Madoff's Ponzi scheme. There is no genuine dispute that of the more than $295 million of fictitious profit received by the Sterling Defendants, BLMIS transferred more than $83 million of that money to the Two-Year Net Winner Defendants within the Two-Year Period.

As a matter of law, the Two-Year Net Winner Defendants did not provide value for, at a minimum, more than $83 million in fictitious profits they received during that Period. Having never disputed the facts that establish the Trustee's right to avoid and recover these transfers, the Two-Year Net Winner Defendants have at last exhausted their legal challenges. The Two-Year

Net Winner Defendants must now return those funds to the estate so they may be distributed fairly among the thousands of defrauded customers of BLMIS's investment advisory business.

## THE UNDISPUTED FACTS

### I. BLMIS WAS ENGAGED IN A PONZI SCHEME AT ALL RELEVANT TIMES.

The facts of Madoff's fraud are not in dispute. As recognized by the Sterling Defendants and various courts, including the United States Court of Appeals for the Second Circuit and this Court, Madoff operated a decades-long, classic Ponzi scheme through BLMIS. *See*, *e.g.*, *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 231-32 (2d Cir. 2011); *Katz*, 2011 WL 4448638, at *2; *e.g.*, *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 387, 389-90 (S.D.N.Y. 2010); Declaration of David J. Sheehan in Support of Trustee's Motion for Partial Summary Judgment ("Sheehan Decl."), Ex. 1, Answer, *Picard v. Katz, et al.*, No. 11 Civ. 3605 (S.D.N.Y. Oct. 11, 2011) (JSR), ECF No. 48, ¶ 1.)

#### A. The Forensic Investigation

After the Trustee was appointed to marshal estate assets and determine customer claims, (Order, *In re Bernard L. Madoff Investment Sec. LLC*, No. 08 Civ. 10791 (S.D.N.Y. Dec. 15, 2008)), the Trustee retained FTI Consulting, Inc. ("FTI"), which specializes in forensic accounting and financial fraud investigative services. (Expert Report of Lisa M. Collura ("Collura Report") attached as Ex. 1 to the Declaration of Lisa M. Collura in Support of Trustee's Motion for Partial Summary Judgment ("Collura Decl.") ¶ 1; Greenblatt Decl., Ex. 1, Expert Report of Matthew B. Greenblatt ("Greenblatt Report") ¶ 4.) The Trustee tasked FTI with analyzing the financial affairs of BLMIS, including reconstructing its books and records, focusing on the transactions related to the investment advisory customer accounts as far back as the records allow. (Collura Decl., Ex. 1, Collura Report ¶¶ 4, 6; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 5-6.)

The Trustee also retained Bruce G. Dubinsky ("Dubinsky"), a managing director at Duff and Phelps, LLC ("D&P") who specializes in forensic accounting and fraud investigations, to conduct an independent review and analysis of the books and records of BLMIS and other source materials and raw data. (Initial Expert Report of Bruce G. Dubinsky, MST, CPA, CFE, CVA, CFF, CFFA ("Dubinsky Report") attached as Ex. 1 to the Declaration of Bruce G. Dubinsky, MST, CPA, CFE, CVA, CFF, CFFA in Support of the Trustee's Motion for Partial Summary Judgment ("Dubinsky Decl.") ¶ 1.)[3] FTI and D&P had access to more than 28 million electronic and hardcopy records, including BLMIS and Madoff bank account records, BLMIS customer statements, trade confirmations, documentation for BLMIS customers dating back to the 1970s, major portions of the computer system used by the investment advisory business, as well as major portions of the computer system used by the market making and proprietary trading business, and documents provided by third parties. (*Id.* ¶¶ 12-16; Collura Decl., Ex. 1, Collura Report ¶¶ 6 n.1, 9; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 38, 59.)

### B. There Is No Genuine Dispute that the Purported Investment Transactions Reflected in BLMIS Customer Statements Never Took Place.

Madoff founded BLMIS as a sole proprietorship in 1960. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶ 28, Dubinsky Decl. Ex. 2; Sheehan Decl., Ex. 1, Answer ¶ 29.) BLMIS operated three business units: a market making business, a proprietary trading business (known

[3] The expert reports of FTI and D&P are attached to the respective declarations of Collura, Greenblatt, and Dubinsky. As explained in their reports, FTI was retained to, among other things, create chronological listings of all cash deposit and withdrawal transactions for every BLMIS customer account from April 1, 1981 through December 11, 2008, reconcile these cash transactions with available non-BLMIS records, and determine the principal balance in each account on a daily basis. (Collura Decl., Ex. 1, Collura Report ¶¶ 5, 11; Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 5.) Dubinsky was retained to determine whether there was any evidence that the investment advisory business was legitimate at any time and whether its books and records showed that it was a Ponzi scheme. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶ 1.)

within BLMIS, together, as "House 5"), and the investment advisory business (known within BLMIS as "House 17"). (Dubinsky Decl., Ex. 1, Dubinsky Report ¶ 28; Dubinsky Decl., Ex. 2; Sheehan Decl., Ex. 1, Answer ¶ 29.) The Ponzi scheme was conducted through the investment advisory business, which funneled substantial amounts of its customers' money to the other divisions of BLMIS. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶ 250, Tables 10.)

Although customers of the investment advisory business received account statements from BLMIS reflecting purported securities transactions relating to supposed investment strategies, none of these strategies were ever implemented and the securities transactions never took place. (*Id.* ¶¶ 19-21, 25, 74-78, 115-22, 242; Dubinsky Decl., Ex. 10, 23-24; Sheehan Decl., Ex. 1, Answer ¶ 30; Sheehan Decl., Ex. 2, Plea Hr'g Tr. ("Madoff Plea") 24:9-17, 25:20-26:18, *United States v. Madoff*, No. 09 Cr. 213 (S.D.N.Y. Mar. 12, 2009) (DC), ECF No. 57.) The Trustee's forensic analyses demonstrate that the purported investment transactions for investment advisory business customers could never have occurred, as far back as the 1970s. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 19, 20, 74-78, 115-22, 242; Dubinsky Decl., Ex. 10, 23-24; Sheehan Decl., Ex. 7, Plea Hr'g Tr. ("Kugel Plea") 32:4-12, *United States v. Kugel*, No. 10 Cr. 228 (S.D.N.Y. Nov. 21, 2011) (LTS), ECF No. 188.)

The available records for all relevant periods show that BLMIS claimed on numerous days to have traded more than the *entire* reported market volume for particular securities; indeed, in many instances, the securities trades reflected on individual investment advisory customer accounts traded more than the entire reported market volume for those securities, meaning that in the aggregate BLMIS was trading multiples of the reported market volume of a particular security at one time—an impossibility. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 72, 76-79, 115-16, Figures 2-4; Dubinsky Decl., Ex. 13 .) BLMIS reported hundreds of thousands of trades

at prices that were impossible because they were outside the range of market-reported trading prices on those given days, and such impossible trading was reported throughout all relevant periods. (*Id.*¶¶ 70, 80-82, 105, 117-22; Dubinsky Decl., Ex. 13.) Thousands of trades were recorded as having settled after hours or on weekends or holidays when the exchanges were closed, and convertible securities were reported as being traded on days when they no longer existed in that form. (*Id.* ¶¶ 22, 83-84, 89-98, 128-29, Table 2; Dubinsky Decl., Ex. 15-19.) Dividends reflected on investment advisory customer statements as having been paid by the respective companies were never received by BLMIS on behalf of its customers. (*Id.* ¶¶ 85-88, 160-68, Figures 5-25, Tables 5-7; Dubinsky Decl., Ex. 14.)

The computer system for the investment advisory business—run from an IBM AS/400 with code and software originating from programs written in the 1970s and '80s— could not have supported a broker-dealer environment where actual trades were being executed. (*Id.* ¶¶ 185-90, 192, Figures 33-34.) The computer system was not connected with any of the standard platforms used in a trading or investment environment, such as the NASDAQ or the Depository Trust & Clearing Corporation ("DTCC")'s subsidiary, DTC. (*Id.* ¶ 190.) Instead, the computer system was used to generate fictitious customer statements, fake trade confirmations, backdated trade histories, and even re-generate monthly statements from prior periods. (*Id.* ¶¶ 193-211; Dubinsky Decl., Ex. 28-31; Sheehan Decl., Ex. 2, Madoff Plea 27:9-16; Sheehan Decl., Ex. 4, Plea Hr'g Tr. ("DiPascali Plea") 47:19-22, *United States v. DiPascali*, No. 09 Cr. 764 (S.D.N.Y. Aug. 11, 2009) (RJS), ECF No. 11; Sheehan Decl., Ex. 8, Plea Hr'g Tr. ("Cotellessa-Pitz Plea") 31:12-15, *United States v. Cotellessa-Pitz,* No. 10 Cr. 228 (S.D.N.Y. Dec. 19, 2011) (LTS).) Not surprisingly, BLMIS employees followed written instructions to increase the fake returns for

certain customers. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 24, 169-84; Dubinsky Decl., Ex. 34-35; Sheehan Decl., Ex. 4, DiPascali Plea 47:19-22.)

No records from the DTC (or other clearing houses or custodians) exist demonstrating any customer trades or securities holdings by the investment advisory business. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶ 138.) The only securities held in BLMIS's account at the DTC were for House 5 clients, as recorded on House 5 trading records. (*Id.*) The investment advisory business's computers contained software capable of generating fictitious DTC reports, and DTC records found in BLMIS's investment advisory files were fake. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 23, 143-53, Figures 16-18; Dubinsky Decl., Ex. 32-33; Sheehan Decl., Ex. 6, Plea Hr'g Tr. ("Lipkin Plea") 32:2-10, *United States v. Lipkin*, No. 10 Cr. 228 (S.D.N.Y. June 6, 2011) (LTS), ECF No. 14.) BLMIS failed to register as an investment adviser with the SEC at any time between 1979, when registration became a requirement, and when Madoff finally registered in 2006. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 212-13; Dubinsky Decl., Ex. 36-38.) Once BLMIS registered as an investment advisor with the SEC, Madoff falsified every report he filed, misrepresenting the number of accounts maintained, customer assets under management, cash on hand, liabilities, and commissions. (*Id.* ¶¶ 214-26; Sheehan Decl., Ex. 2, Madoff Plea 28:10-19; Sheehan Decl., Ex. 4, DiPascali Plea 49:16-21; Sheehan Decl., Ex. 6, Lipkin Plea 33:22-24, 34: 3-5.)

Likewise, despite the requirements of the SEC, New York law, and the American Institute of Certified Public Accountants, BLMIS failed to use an independent accountant, and for his involvement in the scheme, accountant David Friehling pleaded guilty. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 59, 60, 227, 234; Dubinsky Decl., Ex. 49; Sheehan Decl., Ex. 5, Plea Hr'g Tr. ("Friehling Plea") 5:3-4, 35:1-4, *United States v. Friehling*, 09 Cr. 700 (S.D.N.Y. Nov.

3, 2009) (AKH).) BLMIS was "hopelessly" insolvent from at least December 11, 2002 because its debts were greater than the fair value of all its property. (Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 264-303, Appx. C.) Hundreds of millions of dollars of investment advisory customer money was funneled to the other business units of BLMIS, and, by at least 2000, a significant percentage, if not a majority, of the "revenue" reported by Madoff's proprietary and market making businesses was actually customer money from the Ponzi scheme. (Collura Decl., Ex. 1, Collura Report ¶¶ 16, 19-20 and Ex. 4; Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 241-52, Table 10, Figure 45.)

The Trustee's forensic reconstruction of the Ponzi scheme is confirmed by various individuals complicit in the scheme. Recently, David Kugel, a trader at BLMIS, testified:

> Beginning [in] the early '70s, until the collapse of BLMIS in December 2008, I helped create fake, backdated trades. I provided historical trade information to . . . others [BLMIS employees], which enabled them to create fake trades that, when included on the account statements and trade confirmations of Investment Advisory clients, gave the appearance of profitable trading when in fact no trading had actually occurred.

(Sheehan Decl., Ex. 7, Kugel Plea 32:4-12.) BLMIS's Finance Chief testified that after he became involved with the investment advisory business in the late 1980s, he knew that "[n]o purchases or sales of securities were actually taking place in their accounts. It was all fake. It was all fictitious." (Sheehan Decl., Ex. 4, DiPascali Plea 46:12-14.) Madoff himself acknowledged that his "representations were false for many years. Up until I was arrested on December 11, 2008, I never invested these funds in the securities, as I had promised." (Sheehan Decl., Ex. 2, Madoff Plea 24:15-17.)

Madoff pleaded guilty to an eleven-count information, which alleged—and he admitted—that he operated a massive Ponzi scheme through the investment advisory business of BLMIS. (Sheehan Decl., Ex. 2, Madoff Plea 23:14-21; 31:25-32:1.) In addition to Madoff, five

other BLMIS employees and accomplices have pleaded guilty to federal fraud charges for assisting Madoff in operating his Ponzi scheme through the investment advisory business of BLMIS. (Sheehan Decl., Ex. 4, DiPascali Plea 65:6-17; Sheehan Decl., Ex. 5, Friehling Plea 5:3-4; Sheehan Decl., Ex. 6, Lipkin Plea 39:8-40:13; Sheehan Decl., Ex. 7, Kugel Plea 39:2-24; Sheehan Decl., Ex. 8, Cotellessa-Pitz Plea 7:14-16, 37:18-38:15.)

In short, there can be no genuine dispute that BLMIS's investment advisory business was a Ponzi scheme at all times relevant to this litigation.

### C. There Is No Genuine Dispute that Investment Advisory Customer Deposits Supposedly Used for Investments Were Instead Used by BLMIS to Satisfy Other Customers' Redemption Requests.

Customer funds invested with BLMIS's investment advisory business were not used to engage in any securities transactions for its customers, as explained above, but instead were deposited by BLMIS into a bank account at JPMorgan Chase Bank ("JPMorgan"), account number xxx-xxx703 (the "703 Account"). (Collura Decl., Ex. 1, Collura Report ¶¶ 16, 19-20, Ex. 4; Dubinsky Decl., Ex. 1, Dubinsky Report ¶¶ 241-52, Table 10, Figure 45; Sheehan Decl., Ex. 2, Madoff Plea 24:17-18; Sheehan Decl., Ex. 4, DiPascali Plea 47:5-7.) BLMIS used the customer deposits in the 703 Account to fund two BLMIS checking accounts, a JPMorgan account #xxx-xxxxxx509 (the "509 Account") and a Bankers Trust account #xx-xxx-599 (the "BT Account"), which were used almost exclusively for customer redemptions. (Collura Decl., Ex. 1, Collura Report ¶¶ 16, 24-29, Ex. 5-6.)

When BLMIS investment advisory customers submitted redemption requests seeking to withdraw funds they believed they held in their investment advisory business accounts, BLMIS would use the commingled customer deposits held in the 703 Account, and often transferred to the 509 Account and/or the BT Account, to satisfy their requests. (Dubinsky Decl., Ex. 1,

Dubinsky Report ¶¶ 241-52, Table 10, Figure 45; Collura Decl., Ex. 1, Collura Report ¶¶ 16, 19-20, 23-29, Ex. 4-6; Sheehan Decl., Ex. 2, Madoff Plea 24:18-22.)

## II. THE TWO-YEAR NET WINNER DEFENDANTS RECEIVED MORE THAN $83 MILLION IN TRANSFERS OF FICTITIOUS PROFITS FROM BLMIS WITHIN THE TWO-YEAR PERIOD PRIOR TO DECEMBER 11, 2008.

The Sterling Defendants consist of Saul Katz ("Katz"), Fred Wilpon ("Wilpon"), other Sterling Equities partners, their family members, and related entities and trusts, who collectively held over the course of 25 years 185 BLMIS investment advisory customer accounts that are the subject of this litigation. (Greenblatt Report ¶¶ 64-65, Ex. I-J.) Defendants Katz and Wilpon opened their first accounts in or around October 1985. (Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 66, Ex. J; Sheehan Decl., Ex. 1, Answer ¶¶ 62, 69, 743.) They, the remaining partners of Sterling Equities, and their family members each held interests in multiple investment advisory accounts and in different capacities. (Sheehan Decl., Ex. 1, Answer ¶¶ 46, 63, 70, 1102.[4])

Since 1985, BLMIS made transfers totaling $1,757,223,415 to the Sterling Defendants. (Collura Decl., Ex. 1, Collura Report ¶¶ 14, 31, 41; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 12, 67-69, Ex. I -J.). By this Motion, the Trustee seeks to recover the fictitious profits, totaling $83,309,162, which were transferred by BLMIS to the Two-Year Net Winner Defendants within the Two-Year Period. (Greenblatt Decl., Ex. 1, Greenblatt Report, ¶¶ 67-68, 72, Ex. I, J; Greenblatt Decl., Ex. 2.)

[4] (*See also* Sheehan Decl., Ex. 1, Answer ¶¶ 4, 44, 90, 97, 104, 111, 118, 125, 132, 145, 155, 160, 203, 210, 215, 221, 226, 232, 250, 266, 274, 279, 284, 288, 293, 299, 307, 312, 320, 336, 342, 348, 357, 363, 370, 376, 382, 387, 392, 398, 403, 408, 413, 418, 424, 431, 436, 442, 447, 453, 461, 465, 469, 478, 484, 490, 496, 502, 508, 514, 520, 521, 527, 533, 539, 545, 551, 557, 563, 574, 580, 586, 592, 598, 604, 610, 616, 622, 628, 744.)

### A. The Net Investment Method Determines the Value of Each Customer's Net Equity and Principal Balance.[5]

The Trustee is charged with recovering money for the BLMIS estate through various methods, including avoiding fraudulent transfers, to pay customer claims. *See, e.g.*, 15 U.S.C. §§ 78fff(a), 78fff-1, 78fff-2(c). Under SIPA, a customer's claim is determined based upon the net equity of that customer's account. *See, e.g.*, 15 U.S.C. §§ 78fff-1(b), 78fff-4(c). The Second Circuit ruled that the "Net Investment Method," which credits for the life of the account the amount of cash a customer deposited into his account, less any amounts withdrawn from it, was the only legally sound and fair approach to calculate a customer's "net equity" claim under SIPA. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 231, 240 (the "Net Investment Ruling").

As applied to each customer account, the Net Investment Method distinguishes: (1) the accountholders that lost the amount of their principal investment over the course of their investment with BLMIS (referred to as "net losers") from (2) the accountholders that received the return of the principal amount of their investment as well as the principal of other customers in the form of fictitious profits over the course of their investment with BLMIS (referred to as "net winners"). *Id.* at 233; (Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 14-37.) Under the Net

[5] The Trustee addressed this issue in his response to the Court's request to brief "whether the Trustee can avoid as profits only what defendants received in excess of their investment during the two year look back period specified by section 548 or instead the excess they received over the course of their investment with Madoff." *Katz*, 2011 WL 4448638, at *4 n. 6. As discussed in the Trustee's brief, the "reset to zero" method suggested by the court would almost triple the amount the Trustee would be able to avoid and recover as fictitious profits. *See* Trustee's Memorandum of Law Supporting the Calculation of Principal and Fictitious Profit under the Net Investment Method at 10, *Picard v. Katz, et al.*, No. 11 Civ. 3605 (S.D.N.Y. Oct. 25, 2011) (JSR), ECF No. 63.

Investment Ruling, only those accountholders that lost principal are entitled to an allowed customer claim. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 233.

Accordingly, the Trustee applied the Net Investment Method to determine the amount of principal deposits made by customers in each account and whether transfers made by BLMIS to customers constituted the return of amounts representing their principal investment or fictitious profits. Excess transfers made to a customer's account after the customer's investment is exhausted are "fictitious profits."

### B. FTI Identified Every Transfer Made to and by Each BLMIS Customer Account During All Periods Relevant to this Case.

FTI examined BLMIS's records and reconciled them with available third party records. (Collura Decl., Ex. 1, Collura Report ¶¶ 6, 9-10, 12, 32; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 5, 11, 62-63, 71.) Such records included bank records for BLMIS's bank accounts; receiving bank account records; records produced by defendants; and other third party records. (*Id.*) FTI analyzed hundreds of thousands of transactions within the monthly bank statements and cancelled checks and deposit slips, whether found within BLMIS's files or produced by third party financial institutions. (Collura Decl., Ex. 1, Collura Report. ¶ 9.) For the analyzed time period, FTI reconciled 99 percent of the approximately 225,000 cash deposit and withdrawal transactions reflected in all BLMIS investment advisory customer statements, while the majority of the remaining 1 percent consisted primarily of check transactions for which copies of the related, cancelled checks were unavailable. (Collura Decl., Ex. 1, Collura Report ¶¶ 14, 30; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 62-63.)

Based on this data, FTI created chronological listings of all cash deposit and withdrawal transactions for every BLMIS customer account, including the accounts of the Sterling

Defendants, from April 1, 1981 through December 11, 2008. (Collura Decl., Ex. 1, Collura Report ¶¶ 5, 11; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 5, 10, Ex. J.)

On an account-by-account, daily basis, FTI calculated every investment advisory customer account holder's principal balance (the "Principal Balance") from April 1, 1981 through December 11, 2008 based upon the following seven factors:

(1) The initial investment of each customer, which for accounts opened after April 1, 1981 was either a cash deposit or an inter-account transfer;

(2) Cash deposits made by each account holder in the form of checks or wire transfers, which were recorded on customer statements as cash deposits;

(3) Non-cash deposits of principal, such as real securities or bonds, made by customers;

(4) Inter-account transfers "in" to one BLMIS account from another account in which no new funds entered or left BLMIS;

(5) Cash withdrawals (or "redemptions") made by each BLMIS holder and transferred via wire or check;

(6) Inter-account transfers "out" of one BLMIS account to another account in which no new funds entered or left BLMIS; and

(7) Payments made by BLMIS on behalf of an account holder to a third party for apparent legal obligations, such as to the Internal Revenue Service on behalf of foreign account holders.

(Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 5, 16-37.)

"Core Account Documents" were relied upon to calculate Principal Balances for each investment advisory customer account, including: BLMIS customer statements from November 1978 through November 2008, for which the reported cash activity was supported by third party bank records for all periods that such records are available; Portfolio Management Reports generated by BLMIS on a monthly basis; Portfolio Management Transaction Reports created by BLMIS and available for the time periods from January 1985 through December 1986 and from January 1990 through December 1995; spiral bound notebooks containing handwritten

transaction information related almost exclusively to cash receipts and cash disbursements and available for the time periods from April 1985 through September 1990 and from August 1991 through November 1994; and the "Checkbook File," a data table within the investment advisory business's IBM AS/400 computer system that contains manually-inputted cash receipts and cash disbursements, maintained for the time period from January 2000 through December 11, 2008. (*Id.* ¶¶ 38-59.)

### C. There is No Genuine Dispute that the Sterling Defendants Received More Than $83 Million in Fictitious Profits Within the Two-Year Period.

From October 1, 1985 to December 11, 2008, the Sterling Defendants engaged in 5,246 cash transactions—deposits and withdrawals—in the 185 accounts they held. (Collura Decl., Ex. 1, Collura Report, ¶¶ 14, 31; Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 65.) All but 15 of these transactions are reflected on BLMIS investment advisory customer statements; the remaining 15 transactions, which occurred during the first eleven days of December 2008, were traced to the investment advisory business's Checkbook File. (Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 60 and Ex. J.) FTI reconciled 98 percent (or 5,147) of these cash transactions with BLMIS bank records, customer files, and documents/data produced by the Sterling Defendants. (Collura Decl., Ex. 1, Collura Report ¶¶ 14, 31, 37, 54-56, Ex. 7; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 62-63.) The necessary records were unavailable to complete the reconciliation process for the remaining 99 cash transactions, which dated primarily from the late 1980s and early 1990s. (Collura Decl., Ex. 1, Collura Report ¶¶ 14, 54; Greenblatt Decl., Ex. 1, Greenblatt Report ¶¶ 62-63.)

Of the Sterling Defendants' 185 investment advisory accounts, 144 accounts were "net winners" of more than $295 million in fictitious profits withdrawn over the life of the Sterling Defendants' investment. (Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 68, Exs. I and J.) From

that group, the Two-Year Net Winner Defendants received transfers of $83,309,162 in fictitious profits from 34 accounts within the Two-Year Period. (*Id.* ¶¶67-68, 27, Ex. I, Ex. J; Greenblatt Decl., Ex. 2.)

## ARGUMENT

### I. SUMMARY JUDGMENT STANDARD

Rule 56(a) of the Federal Rules of Civil Procedure provides that summary judgment must be granted, in whole or in part, when "there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986); *Fed. Ins. Co. v. Am. Home Assurance Co.*, 639 F.3d 557, 566 (2d Cir. 2011). Substantive law determines whether facts are material. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986) (finding that a fact is material "if it might affect the outcome of the suit under the governing law."). Factual positions are proven by either citing the record evidence or showing that an adverse party cannot produce admissible evidence to support a fact. Fed. R. Civ. P. 56(c)(1); *Matsushita Elec. Indus. Co. Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986). Indeed, the movant need not show the absence of a genuine dispute of material fact with respect to a point "on which the nonmoving party bears the burden of proof." *Celotex Corp.*, 477 U.S. at 325.

To defeat summary judgment, the non-movant must put forth probative evidence to contradict the evidence put forward by the movant. *Id.* at 324. If the non-movant fails to come forward with specific, probative facts showing that there is a genuine dispute of fact for trial, summary judgment is appropriate. *Matsushita*, 475 U.S. at 586-87; *Ying Jing Gan v. City of New York*, 996 F.2d 522, 532 (2d Cir. 1993) ("[T]he nonmoving party may . . . not rely simply on conclusory statements or on contentions that the affidavits supporting the motion are not credible."). Summary judgment must be granted if the non-movant fails to offer "concrete

evidence from which a reasonable juror could return a verdict in his favor." *Liberty Lobby, Inc.*, 477 U.S. at 256; *accord Greenwood v. Koven*, 880 F. Supp. 186, 202-03 (S.D.N.Y. 1995) (granting summary judgment where requisite inference was "simply unbelievable").

There is no genuine dispute as to any material fact with respect to the fictitious profits sought in Count One of the Amended Complaint.

## II. THE EVIDENCE DEMONSTRATES AS A MATTER OF LAW THAT BLMIS RAN THE INVESTMENT ADVISORY BUSINESS AS A PONZI SCHEME AT ALL RELEVANT TIMES.

There is no genuine dispute that BLMIS was engaged in a Ponzi scheme at all relevant times. The existence of the scheme has been recognized by numerous courts, including this Court and the Second Circuit. Madoff and five other employees pleaded guilty to federal criminal charges and are facing lengthy jail sentences. The contours and scope of the Ponzi scheme have been revealed by the examination and analysis of millions of documents by the Trustee's forensic accountants and experts. The Sterling Defendants have never challenged the fundamental fact that they were invested in a Ponzi scheme that did not implement its purported investment strategies or engage in the securities transactions reflected on their customer statements.[6]

Collectively, the evidence before the Court constitutes uncontroverted and "overwhelming evidence of actual fraudulent intent" warranting summary judgment. *Christian*

[6] The Sterling Defendants objected before both the bankruptcy court and the Second Circuit to the Trustee's use of the "cash in/cash out" method to determine an accountholder's "net equity" for the purpose of determining claims. They did not, however, object before either court to the factual premise underlying the Trustee's method; namely, that the investment advisory business was a Ponzi scheme at all relevant times, in that none of the purported investment strategies were ever implemented and the securities transactions never took place. Indeed, the Sterling Defendants characterize themselves as "victims" of the "Ponzi scheme." (Sheehan Decl., Ex. 1, Answer ¶ 1.)

*Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC* (*In re Bayou Group LLC*), 439 B.R. 284, 305, 307-08 (S.D.N.Y. 2010) ("*Bayou IV*") (affirming summary judgment on fictitious profits from Ponzi scheme based on testimony of SIPA trustee's forensic accountant and guilty pleas of fraudsters). Indeed, the guilty pleas by BLMIS's principals and employees alone establish fraudulent intent as a matter of law.[7] Here, the existence of the Ponzi scheme is confirmed by the Trustee's extensive investigation of BLMIS's books and records, third party documents, and documents provided by various defendants, detailed in the reports of Dubinsky, Collura, and Greenblatt.

It thus is established as a matter of law that every customer of the investment advisory business was invested in a Ponzi scheme at all relevant times. *Bayou IV*, 439 B.R. at 305, 307-08; *Scholes v. Lehmann*, 56 F.3d 750, 762-63 (7th Cir. 1995) (affirming district court's reliance on guilty plea and affidavit of accountant who studied books of the debtor in finding actual intent to defraud); *Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 12 (S.D.N.Y. 2007) ("*Gredd V*"); *Donell v. Kowell*, 533 F.3d 762, 773 (9th Cir. 2008), *cert. denied*, 129 S. Ct. 640 (2008) (admitting certified public accountant's report based on records held by bank and Ponzi scheme perpetrator to calculate customer's profit from scheme); *Terry v. June*,

[7] *See, e.g., Scholes v. Lehmann*, 56 F.3d 750, 761-62 (7th Cir. 1995) (admitting Ponzi scheme principal's admission of fraud in plea agreement as evidence of actual fraudulent intent in fraudulent transfer suit); *Bayou IV*, 439 B.R. at 305, 307 (finding that admissions in guilty pleas regarding dissemination of falsified value of investors' accounts evidenced debtors' fraudulent intent in making redemption payments and "more than sufficient to establish the Bayou principals' actual fraudulent intent."); *Gredd V*, 397 B.R. at 12 (relying on guilty pleas and convictions, alone, to establish the existence of a Ponzi scheme and the debtor's actual fraudulent intent); *Sec. Inv. Protection Corp. v. Old Naples Sec., Inc. (In re Old Naples Sec., Inc.)*, 343 B.R. 310, 320 (Bankr. M.D. Fla. 2006) (finding testimony of SIPA trustee that fraud was a "classic Ponzi scheme" and Ponzi scheme principal's guilty plea sufficient for trustee to avoid and recover fictitious profits).

432 F. Supp. 2d 635, 639 (W.D. Va. 2006) (awarding summary judgment to receiver based on expert opinion that debtor was Ponzi scheme and fraudster's criminal conviction); *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*, 396 B.R. 810, 841 (Bankr. S.D.N.Y. 2008) ("*Bayou III*") ("There can be no question that the compilations and summaries [of 'all available source documents, including the books and records of all of the [debtors] and all third-party source documents including bank account and brokerage accounts records for the [debtor] entities'] which comprise the [expert] report are appropriate and proper under Rule 1006" on summary judgment); *Wing v. Williams*, No. 2:09 Civ. 399, 2011 WL 891121, at *4 (D. Utah Mar. 11, 2011) (relying on expert report to establish, among other things, that "the characteristics of a ponzi scheme existed from at least the year 2000.").

## III. THE TRUSTEE IS ENTITLED TO SUMMARY JUDGMENT AVOIDING THE TRANSFERS OF FICTITIOUS PROFITS MADE BY BLMIS TO THE TWO-YEAR NET WINNER DEFENDANTS.

Section 548(a)(1)(A) of the United States Bankruptcy Code (the "Bankruptcy Code"), 11 U.S.C. §§ 101 *et seq.*, authorizes the trustee to avoid the *entire* amount of "any transfer" of an interest in property of the debtor made within two years of the filing date with actual intent to hinder, delay, or defraud creditors. 11 U.S.C. § 548(a)(1)(A); *Katz*, 2011 WL 4448638, at *3. Section 548(a)(1)(A) allows the avoidance of both (1) fictitious profits and (2) amounts that represent the repayment of a principal investment. *Bayou IV*, 439 B.R. at 304; *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC)*, 362 B.R. 624, 630 (Bankr. S.D.N.Y. 2007) ("*Bayou I*") (finding avoidance of all transfers particularly apt in a Ponzi scheme recovery proceeding). This is true "whether or not the debtor received value in exchange" for the transfers. *Bayou III*, 396 B.R. at 26; *Bayou I*, 362 B.R. at 629.

Because there is no genuine dispute regarding BLMIS's (1) transfer of funds to the Defendants within the Two Year Period, December 11, 2008; (2) interest in the transferred

funds; and (3) actual intent to hinder, delay, or defraud its creditors in making the transfers, the Trustee is entitled to avoid all transfers made to the Two-Year Net Winner Defendants unless they can demonstrate that they received the transfers "in good faith" and "for value." *McHale v. Boulder Capital LLC (In re The 1031 Tax Group, LLC)*, 439 B.R. 47, 68 (Bankr. S.D.N.Y. 2010) ("Summary judgment [on a fraudulent transfer claim] is appropriate if the Trustee offers evidence satisfying these elements . . . ."); *Bayou III*, 396 B.R. at 825-26 (same); *Bayou I*, 362 B.R. at 629 (same).

### A. BLMIS Made Transfers To The Two-Year Net Winner Defendants Within Two Years Of December 11, 2008.

By this Motion, the Trustee seeks to avoid the two-year fictitious profits transferred from BLMIS to the Two-Year Net Winner Defendants. Under section 548(a)(1)(A) of the Bankruptcy Code, all fraudulent transfers made within two years of the Filing Date are avoidable and recoverable pursuant to section 550 of the Bankruptcy Code. 11 U.S.C. § 548(a)(1); *In re The 1031 Tax Group, LLC*, 439 B.R. at 71.

The uncontroverted evidence shows that BLMIS made the transfers of fictitious profits to the Two-Year Net Winner Defendants between December 11, 2006 and December 11, 2008. (Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 68, Ex. J; Greenblatt Decl, Ex. 2, Summary of Two-Year Transfers from BLMIS to Defendants in Excess of Principal.) For purposes of avoidance and recovery, BLMIS is deemed to have an interest in the transferred property under SIPA; thus, the transfers here are avoidable under section 548 of the Bankruptcy Code. *See* 15 U.S.C. § 78fff-2(c)(3) ("For purposes of such recovery [through a trustee's avoidance action], the property so transferred shall be deemed to have been the property of the debtor and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding."); *In re The 1031 Tax Group,*

*LLC*, 439 B.R. at 58, 68-70 (finding that, in a Ponzi scheme, money reflected in bank account statements "in the name of a debtor is presumed to be property of the bankruptcy estate" for purposes of 11 U.S.C. § 548(a)(1)); *Sec. Inv. Protection Corp. v. Old Naples Sec., Inc. (In re Old Naples Sec., Inc.)*, 343 B.R. 310, 319 (Bankr. M.D. Fla. 2006). The Two-Year Net Winner Defendants have not contested their receipt of such transfers.

**B. BLMIS Made Every Transfer with Actual Fraudulent Intent.**

**1. Because BLMIS was a Ponzi scheme, as a matter of law BLMIS intended to defraud its creditors with every transfer.**

Actual fraudulent intent is established as a matter of law when "the debtor runs a Ponzi scheme or a similar illegitimate enterprise." *Bayou IV*, 439 B.R. at 304-05 ("Actual fraudulent conveyance claims . . . turn on the intent of the debtor in making the transfer; the state of mind of the transferee is irrelevant."); *Bayou III*, 396 B.R. at 825-26; *Bayou I*, 362 B.R. at 631.

This is because transfers made in the course of a Ponzi scheme "could have been made for no purpose other than to hinder, delay or defraud creditors." *Bayou IV*, 439 B.R. at 305 (citing, *e.g.*, *Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510, 517-18 (Bankr. S.D.N.Y. 2007) ("*Gredd IV*")); *In re The 1031 Tax Group, LLC*, 439 B.R. at 72; *Breeden v. Bennett (In re The Bennett Funding Group, Inc.)*, 220 B.R. 743, 754, 756, 758 (Bankr. N.D.N.Y. 1997) (entering summary judgment on question of fraudulent intent where debtor did not receive consideration in exchange for transfers).

On a motion for summary judgment, "it is sufficient for a plaintiff to demonstrate that the transferor acted under circumstances that preclude any reasonable conclusion other than that the purpose of the transfer was fraudulent as to creditors." *Bayou III*, 396 B.R. at 827 (affirming grant of summary judgment on fictitious profits despite disagreement of experts about whether debtor operated a Ponzi scheme because "there is no precise definition of a Ponzi scheme and

courts look for a general pattern, rather than specific requirements."). "Courts have determined that Ponzi schemes are 'any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors.'" *In re The 1031 Tax Group, LLC*, 439 B.R. at 72 (quoting *Danning v. Bozek (In re Bullion Reserve of N. Am.)*, 836 F.2d 1214, 1219 n.8 (9th Cir. 1988) (citing cases). Accordingly, there can be no reasonable conclusion other than that BLMIS made transfers with fraudulent intent when it:

1. used money from new investors to pay artificially high returns to earlier investors;
2. continuously falsified performance;
3. sent account statements to current investors reflecting significant gains; and
4. concealed the true state of the debtor's financial condition.

*See Gredd V*, 397 B.R. at 8, 12; *In re The 1031 Tax Group, LLC*, 439 B.R. at 72; *Bayou III*, 396 B.R. at 829-31. As discussed at length above, BLMIS carried out these acts hundreds of thousands of times, for decades.

**2. BLMIS's transfers to the Sterling Defendants were in furtherance of the fraud.**

To avoid a transfer as actually fraudulent, a trustee need not prove that the debtor intended to hinder, delay, or defraud a particular creditor, but rather need only establish that the transfers made to the subject transferee were "in furtherance" of the fraudulent scheme. *See Bayou IV*, 439 B.R. at 304; *Bayou III*, 396 B.R. at 826 (citing 5 Collier on Bankruptcy ¶ 548.04[1] (15th ed. rev. 2006)).

"Every payment made by the debtor to keep the scheme on-going was made with the actual intent to hinder, delay or defraud creditors, primarily the new investors." *Gredd IV*, 359 B.R. at 518 (internal citation omitted); *Gredd V*, 397 B.R. at 13 (finding transfers to Bear Stearns "essential to the continuation of the scheme" because accounts held with Bear Sterns enabled

Ponzi scheme to grow and continue). This is because, in a Ponzi scheme, the failure to honor an investor's withdrawal request "would promptly have resulted in demand, investigation, the filing of a claim and disclosure of the fraud." *Bayou III*, 396 B.R. at 843. Thus, every redemption payment "*in and of itself* constituted an intentional misrepresentation of fact" of the investor's rights to their falsely inflated account statement and "an integral and essential part" of the fraud. *Id.* (emphasis in original).

The transfers to the Sterling Defendants, like the payments made to customers in any Ponzi scheme, were an integral and essential part of BLMIS's fraudulent scheme. Thus, there is no dispute that BLMIS made all transfers to the Sterling Defendants and other customers and creditors with the actual intent to defraud required to support a fraudulent transfer claim under section 548(a)(1)(A) of the Bankruptcy Code.

### C. The Two-Year Net Winner Defendants received transfers of more than $83 million in fictitious profits.

The record establishes as a matter of law that the Trustee may recover $83,309,162 from the Two-Year Net Winner Defendants of the almost $300 million in fictitious profits which the Sterling Defendants received.

In cases involving fraudulent schemes where the payments by the debtor are comprised of principal and fictitious profits, courts apply a two-step process to (1) determine the full extent of a transferee's liability and (2) calculate the amount recoverable under the relevant statutory scheme. The first step is to determine whether the investor is liable through the use of the "netting rule," *Donell*, 533 F.3d at 771. This rule is synonymous with the Net Investment Method upheld by the Second Circuit in this liquidation.

In *Donell*, an investor in a Ponzi scheme deposited $22,858.92 and withdrew $73,290.70 over the life of his account, resulting in $50,431.78 of fictitious profits. *Id.* at 773. The Ninth

Circuit found that the receipt of these fictitious profits over the life of the account established the investor's liability, stating:

> Amounts transferred by the Ponzi scheme perpetrator to the investor are netted against the initial amounts invested by that individual. If the net is positive, the receiver has established liability, and the court then determines the actual amount of liability, which may or may not be equal to the net gain, depending on factors such as whether transfers were made within the limitations period . . . .

*Id.* at 771; *see also Armstrong v. Collins*, Nos. 01 Civ. 2437, 02 Civ. 2796, 02 Civ. 3620, 2010 WL 1141158, at *29 (S.D.N.Y. March 24, 2010); *Noland v. Morefield (In re Nat'l Liquidators, Inc.)*, 232 B.R. 915, 918 n.2 (Bankr. S.D. Ohio 1998). This analysis comports with the Second Circuit's affirmance of the Net Investment Method, which looks to whether the accountholder's transactions over the life of his investment in the Ponzi scheme resulted in positive (greater deposits than withdrawals) or negative (greater withdrawals than deposits) net equity. *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 233.

The second step is to determine the actual amount of liability under the relevant fraudulent conveyance statutes, i.e., the amount of avoidable transfers the trustee may recover. *Donell*, 533 F.3d at 772. While all transfers of fictitious profits in a Ponzi scheme are avoidable as fraudulent transfers, *see, e.g.*, *Bayou IV*, 439 B.R. at 337-38; *Bayou I*, 362 B.R. at 629-30; *Wing v. Dockstader*, No. 2:08 Civ. 776, 2010 WL 5020959, at *5 (D. Utah Dec. 3, 2010), the applicable statutory look back period restricts the time period in which specific transfers may be avoided. *Donell*, 533 F.3d at 772 ("Only transfers made within the limitations period are avoidable."). Regardless of the look back period for transfers, however, courts hold that the deposits must be viewed over the life of the account to determine whether transfers within the avoidance period consist of fictitious profit or principal. *See, e.g., id.* at 771; *In re Nat'l Liquidators, Inc.*, 232 B.R. at 918-20; *see also In re Moore*, 39 B.R. 571, 573 (Bankr. M.D. Fla.

1984) (netting account activity for life of account and holding investor liable for transfers of fictitious profits during avoidance period).

Thus, in *Donell*, once the district court calculated the "good faith" investor's potential liability for the receipt of avoidable transfers by netting his withdrawals against his investments during the life of the account, the court "properly limited" the recovery to the three transfers of fictitious profits totaling $26,396.10 that occurred during the applicable four-year statute of limitations period under California law. *Id.* at 773.

While the Court has ruled that the Trustee's recovery is limited to the Two-Year Period, the evidence demonstrates that the Sterling Defendants withdrew $295,465,565 of fictitious profits from 144 of their accounts over the life of those accounts. (Greenblatt Decl., Ex. 1, Greenblatt Report ¶ 68, Exs. I and J.) Of that amount, $83,309,162 was transferred by BLMIS through the investment advisory business to the Two-Year Net Winner Defendants within the Two-Year Period. (*Id.;* Greenblatt Decl, Ex. 2, Summary of Two-Year Transfers from BLMIS to Defendants in Excess of Principal.) The Trustee is entitled as a matter of law to avoid and recover these fictitious profits.

### D. As a Matter of Law, a Transferee Can Never Give Value for Fictitious Profits.

Having established that BLMIS transferred funds to the Two-Year Net Winner Defendants with actual fraudulent intent and the amount of avoidable transfers under the applicable statute of limitations, the Trustee is entitled to avoid and recover such transfers. To defeat the avoidance of a transfer on summary judgment, the transferee must offer evidence sufficient to create a material issue of fact as to whether it took (1) "for value . . . to the extent that [it] gave value to the debtor in exchange for such transfer" *and* (2) "in good faith." *Bayou IV*, 439 B.R. at 308 (alteration in original) (placing burden of proving affirmative defense on

transferee in trustee's motion for summary judgment); 11 U.S.C. § 548(c); *In re The 1031 Tax Group, LLC*, 439 B.R. at 73; *Bayou III*, 396 B.R. at 844; *Bayou I*, 362 B.R. at 631. Fictitious profits "may be recovered regardless of the customers' good faith," this Court explained, because "transfers made by Madoff Securities to its customers in excess of the customers' principal—that is, the customers' profits—. . . were in excess of the 'extent' to which the customers gave value[.]" *Katz*, 2011 WL 4448638, at *3.

As a matter of law, the Two-Year Net Winner Defendants cannot establish that they took the transfers of fictitious profits "for value" because the profits were not on account of a valid antecedent debt. 11 U.S.C. § 548(d)(2)(A). This Court already rejected the Sterling Defendants' argument that "as long as they acted in good faith, their profits, as reflected in Madoff Securities' monthly statements to them purporting to reflect actual securities trades, were legally binding obligations of Madoff Securities, so that any payments of those profits to the customers were simply discharges of antecedent debts." *Katz*, 2011 WL 4448638, at *4.

It is universally accepted that when investors invest in a Ponzi scheme, payments by the debtor that exceed their investment (i.e., fictitious profits) constitute fraudulent transfers recoverable by the Trustee. *E.g.*, *Bayou I*, 362 B.R. at 636. In fact, "virtually every court to address the question has held *unflinchingly* 'that to the extent that investors have received payments in excess of the amounts they have invested, those payments are voidable as fraudulent transfers." *Id.* (emphasis added) (quoting *Soulé v. Alliot (In re Tiger Petroleum Co.)*, 319 B.R. 225, 239 (Bankr. N.D. Okla. 2004)). Accordingly, transfers of fictitious profits can never be "for value." *Bayou III*, 396 B.R. at 843 ("Redemption payments in respect of fictitious profits are not subject to the affirmative defense under Section 548(c), because the 548(c) defense applies only 'to the extent that such transferee . . . gave value to the debtor in exchange for such transfer.").

When a customer redeems "profits" from a Ponzi scheme, which consist exclusively of other customers' money, such customer does not provide an "equivalent benefit to the estate." *Scholes*, 56 F.3d at 757 (stating that transferee was "entitled to his profit [from a Ponzi scheme] only if the payment of that profit . . . was offset by an equivalent benefit to the estate," and finding that "[i]t was not."); *Jobin v. Lalan (In re M&L Bus. Mach. Co.)*, 160 B.R. 851, 858 (Bankr. D. Colo. 1993) ("[F]or this excess received by an investor in a Ponzi scheme the Debtor does not receive a reasonably equivalent value, nor does the investor give value for this excess."); *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 869 (D. Utah 1987) ("[P]ayments of fictitious profits to investors in a Ponzi scheme are not made for a reasonably equivalent value and thus are avoidable as fraudulent conveyances."); Mark A. McDermott, *Ponzi Schemes and The Law of Fraudulent and Preferential Transfers*, 72 Am. Bankr. L.J. 157, 164-70 (1998) (stating that "[a]lmost all courts have held that a debtor does not receive reasonably equivalent value . . . for any payments made to its investors which represent fictitious profits.").

Judge Posner explained, from an economic standpoint, that fictitious profits can never be received for value because:

> A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits to [the defendant] not offset by further investments by him conferred no benefit on the corporations but merely depleted their resources faster.

*Scholes*, 56 F.3d at 757. This Court, in recognizing the Two-Year Net Winner Defendants' difficulty in proving value, agreed and invited summary judgment briefing for this reason. *Katz*, 2011 WL 4448638, at *4 n.6; 10A Fed. Prac. & Proc. Civ. § 2720 (3d ed.) ("As a practical matter, the court always can 'invite' the appropriate party to move under Rule 56 when it thinks

the case is ripe for summary disposition."). Accordingly, as a matter of law, the Two-Year Net Winner Defendants did not exchange value for the fictitious profits they received.

## IV. THE FICTITIOUS PROFITS ARE RECOVERABLE UNDER SECTION 550 OF THE BANKRUPTCY CODE AND SIPA § 78fff-2(c)(3)

Section 550 of the Bankruptcy Code allows a trustee to recover a transfer of property (or the value thereof), which is avoided under section 548(A)(1)(a) of the Bankruptcy Code from either: "(1) the initial transferee of such transfer or the entity from whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transfer [i.e., subsequent transferees]." 11 U.S.C. § 550(a). Similarly, SIPA section 78fff-2(c)(3) allows the trustee to "recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of title 11." 15 U.S.C. § 78fff-2(c)(3).

The undisputed record establishes that the Two-Year Net Winner Defendants are initial transferees of the two year fictitious profits from BLMIS. The Trustee can, therefore, recover the avoidable transfers from them under section 550(a)(1) of the Bankruptcy Code and SIPA § 78fff-2(c)(3) for the equitable, *pro rata* distribution of funds to the defrauded customers of the investment advisory business.

## CONCLUSION

For the foregoing reasons, the Trustee respectfully requests that the Court grant summary judgment on Count One of the Trustee's Amended Complaint and enter an order avoiding the transfers of fictitious profits made by BLMIS through its investment advisory business to the Two-Year Net Winner Defendants within the Two-Year Period, and directing the Two-Year Net Winner Defendants to return such transfers or the value thereof to the Trustee.

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Respectfully submitted,

**BAKER & HOSTETLER LLP**

By:/s/ *David J. Sheehan*

Baker & Hostetler LLP
45 Rockefeller Plaza
New York, New York 10111
Telephone: (212) 589-4200
Facsimile: (212) 589-4201
David J. Sheehan
Email: dsheehan@bakerlaw.com

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