UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendants.	Adv. Pro. No. 08-1789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
In re BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. LEGACY CAPITAL LTD., ISAAC JIMMY MAYER, RAFAEL MAYER, DAVID MAYER, KHRONOS LLC, KHRONOS CAPITAL RESEARCH LLC, BNP PARIBAS SECURITIES CORP., HCH MANAGEMENT COMPANY LTD., MONTPELLIER RESOURCES LTD., INVERSIONES COQUE S.A., AURORA RESOURCES LTD., and OLYMPUS ASSETS LDC, Defendants.	Adv. Pro. No. 10-05286 (BRL) 11 Civ. 07764 (JSR) 11 Civ. 07765 (JSR)

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Irving H. Picard, as trustee ("Trustee") for the substantively consolidated liquidation proceedings of Bernard L. Madoff Investment Securities LLC ("BLMIS") under the Securities Investor Protection Act ("SIPA"),[1] 15 U.S.C. §§ 78aaa *et seq.*, and the estate of Bernard L. Madoff ("Madoff," and together with BLMIS, each a "Debtor" and collectively, the "Debtors"), by and through his undersigned counsel, hereby submits this memorandum of law in opposition to the Motions to Withdraw the Reference (the "Motions") and accompanying Memoranda of Law filed in the following action: *Picard v. Legacy Capital Ltd., et al.*, Adv. Pro. No. 10-05286 (Bankr. S.D.N.Y.) (BRL),[2] No. 11 Civ. 07764,[3] No. 11 Civ. 07765[4] (JSR) (S.D.N.Y.) (ECF No. 1) (the "Legacy Capital Action").[5]

PRELIMINARY STATEMENT

Through the Motions, the Defendants have inappropriately sought to invoke this Court's jurisdiction while seeking to deprive the bankruptcy court of its central role of ensuring the ratable distribution of customer property to all customers—who have filed over 16,000 customer claims—in the largest SIPA liquidation in history. The Defendants are blatantly engaging in

[1] The Securities Investor Protection Act ("SIPA") is found at 15 U.S.C. §§ 78aaa *et seq*. For convenience, subsequent references to SIPA will omit "15 U.S.C."

[2] A copy of the complaint filed by the Trustee against the Defendants is annexed to the Warshavsky Decl. as Exhibit 1.

[3] This is one of two related Motions filed in this action (hereinafter, the "Legacy Capital Motion"), on behalf of the following defendants: Legacy Capital, Ltd. ("Legacy"), Montpellier Resources Ltd. ("Montpellier"), Khronos LLC, Khronos Capital Research LLC ("Khronos"), Rafael Mayer, David Mayer, and Isaac Jimmy Mayer (the "Mayers").

[4] This is the other of the two related Motions filed in this action (hereinafter, the "BNP Paribas Motion"), on behalf of defendant, BNP Paribas Securities Corp. ("BNP Paribas") (together with Legacy, Montpellier, Khronos, and the Mayers, the "Defendants").

[5] Pursuant to a chambers conference on January 6, 2012, the Court consolidated the two Motions for briefing purposes and permitted the Trustee to file one brief in opposition to the Motions, not to exceed 30 pages.

forum shopping by seeking to bypass the bankruptcy court and withdraw actions involving quintessentially "core" bankruptcy causes of action that Congress intended the bankruptcy courts to hear and determine in the first instance.

The Defendants have seized upon certain narrow rulings by this Court, and seek to convert section 157(d) into an "escape hatch" out of the bankruptcy court. Through this procedural gamesmanship, the Defendants are perverting section 157(d). Indeed, this is precisely the type of conduct against which courts in this Circuit have routinely cautioned. This should not be permitted in the face of clear Second Circuit precedent narrowly construing section 157(d) and giving deference to bankruptcy courts to address purely core matters. None of the issues raised in the Motions require *substantial and material consideration* of non-bankruptcy federal law.

In short, the bankruptcy court is the proper forum for litigating questions of bankruptcy law and claims against the Debtor in this SIPA proceeding.[6] And it is the bankruptcy court that should determine, in the first instance, the meaning and scope of the provisions of the Bankruptcy Code as applied in this SIPA bankruptcy liquidation proceeding—fundamental questions of bankruptcy law that require nothing more than construction and application of the Bankruptcy Code. Accordingly, the Motions should be denied.

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[6] Here, the Trustee seeks to avoid and recover fraudulent transfers that the Defendants received from BLMIS preceding the commencement of the SIPA proceeding. SIPA § 78fff-1(b) expressly incorporates the Bankruptcy Code and specifies that a SIPA proceeding is to "be conducted in accordance with, and as though it were being conducted under" the Bankruptcy Code and governed by relevant provisions of title 11. Moreover, SIPA § 78eee(b)(4) specifically requires that "[u]pon the issuance of a protective decree and appointment of a trustee … the court *shall* forthwith order the removal of the entire liquidation proceeding to the court of the United States in the same judicial district having jurisdiction over cases under title 11."

ALLEGATIONS IN THE COMPLAINT

The Mayers have been on actual or inquiry notice of fraud at BLMIS since 1992. *See* Complaint, Adv. Pro. No. 10-05286 (hereinafter referred to as "Compl.") (¶ 52). Their creation and management of at least six BLMIS accounts (the "Legacy Capital Account" and the "Pre-Legacy Accounts") exposed them to countless red flags signaling irregular and improper trading activity at BLMIS. (*Id.*). As sophisticated financial professionals who received fees for their purported services to the BLMIS accounts, the Mayers either knew or should have known BLMIS was engaged in fraudulent activities which they disregarded. (*Id.*).[7]

Throughout their investment relationship with Madoff, the Mayers and Khronos LLC never conducted any independent, meaningful or reasonable due diligence on their BLMIS investments. (*Id.* ¶ 7). Khronos LLC served as Legacy Capital's administrator and investment manager until on or about July 26, 2004 (*id.* ¶ 68), and was responsible for monitoring, overseeing, and performing risk management and due diligence concerning Legacy Capital's investments. On information and belief, Khronos LLC never adequately performed this diligence and delegated all such responsibility to BLMIS and Madoff. (*Id.* ¶ 70).

This remained the case even after an indirect investor of Legacy Capital, Renaissance analyzed Legacy Capital's account statements and trade confirmations, and confronted the Mayers with numerous indicia of fraud at BLMIS. (*Id.* ¶ 75). For example, in a November 13, 2003 e-mail, Nathaniel Simons explained to Rafael Mayer that Renaissance was concerned about

[7] The Defendants mischaracterize the Trustee's allegations related to non-party Renaissance Technologies Corp. ("Renaissance"). Legacy Capital Motion at 5. The Defendants assert that the Trustee relied on only one e-mail from Nathaniel Simons, a Renaissance executive, to Rafael Mayer, to "claim that Renaissance somehow placed Defendants on inquiry notice that BLMIS was a fraud." *Id.* However, the Trustee did not allege that Renaissance informed Rafael Mayer that BLMIS was a fraud, but rather informed him (and Khronos LLC) about indicia of fraud related to the Legacy Account and BLMIS. The Trustee has evidentiary support for his allegations and details the relevant e-mail communications between the Defendants and Renaissance in the Complaint. *See* Compl. ¶¶ 72-99.

its investment with Madoff through Legacy Capital and specifically took issue with the numerous empirical anomalies and irregularities found in the Legacy Capital Account statements. (*Id.* ¶ 77). Simons also indicated that Renaissance interviewed a former employee of BLMIS who confirmed Renaissance's suspicions that Madoff was not being honest in how he operated BLMIS on behalf of his investors, and suggested that Madoff cherry-picked his trades for his investment business. (*Id.* ¶ 78). Simons also reported to Rafael Mayer his concerns over the lack of internal controls at BLMIS, finding it troubling that Madoff's sons were at high-level positions with BLMIS and that BLMIS's auditor was Madoff's brother in law. (*Id.* ¶ 79). Simons went further, asking Rafael Mayer about Madoff's unorthodox fee structure, asking "why does [Madoff] let us make so much money? Why doesn't he capture that for himself?" (*Id.* ¶ 80). On information and belief, Simons' e-mail is one of many communications between the Mayers and Renaissance regarding irregular activity by Madoff and BLMIS. (*Id.* ¶ 81).

Unlike Renaissance, Legacy Capital, the Mayers and Khronos never performed a straightforward empirical analysis of the Legacy Capital Account statements. Their refusal to conduct even the most rudimentary due diligence on Madoff and BLMIS resulted from the Mayers' desire to continue profiting from Madoff and BLMIS. As Renaissance employee Paul Broder stated in his interview with the SEC:

> [I]t was difficult for [Legacy Capital, HCH, the Mayers and the Khronos Defendants] to do due diligence with – against Madoff, you know. There's a certain sensitivity to questions and kind of things . . . They didn't want to upset – you didn't walk in to a guy and say, are you really telling us the truth? So they had to . . . treat him with kind of kid gloves because of that.

(*Id.* ¶ 92.) As sophisticated investors, Legacy Capital, the Mayers, and Khronos were capable of undertaking the analysis Broder performed on the Legacy Capital Account statements, requiring

only a basic understanding of market data and simple mathematics. Another Renaissance employee, Henry Laufer explained to the SEC:

> This is not rocket science. . . . This is not . . . proprietary Renaissance analysis here. . . . Paul Broder would not claim to be a mathematician, and he's an expert of this, and he's very smart. But you don't have to be as smart as Paul Broder is to do what he says here.

(*Id.* ¶ 93). What's more, in a December 11, 2003 email Broder coached Rafael Mayer on the questions the Mayers were to ask Madoff on Renaissance's behalf. (*Id.* ¶ 95). The questions reflected Renaissance's concerns regarding the volume and timing of the options trades Madoff purportedly traded on Legacy Capital's behalf. This correspondence demonstrates that neither Broder nor Rafael Mayer expected Madoff to have a legitimate explanation for any of the anomalies. For example, with respect to questioning Madoff about his options trading practice, Broder instructed:

> First ask [Madoff how he would hedge out the other side of the trade]. To which we strongly expect an answer that he does this OTC. Then ask (in innocent amazement!): So you can do this kind of volume on OEX OTC Options!?! . . . Gee, what kind of banks are big enough to [trade with you] (more animated amazement!!!)

(*Id.* ¶ 96). In the face of these indicia of fraud, Renaissance later withdrew and liquidated their direct and indirect investments with BLMIS but the Mayers and Khronos continued to invest with and profit from BLMIS. (*Id.* ¶ 98).

BNP Paribas also profited from the Legacy Capital Account once it assumed control of the Legacy Capital Account. (*Id.* ¶ 10). BNP Paribas entered into a security agreement with Legacy Capital under which it undertook to safeguard the funds in the Legacy Capital Account. (*Id.*). On information and belief, BNP Paribas delegated its custodial duties under the security

agreement to Madoff and BLMIS. (*Id.*). On information and belief, the same is true for its managerial duties. Yet, BNP Paribas was still handsomely compensated for its "services." (*Id.*).

BACKGROUND

A. Commencement of the SIPA Liquidation

Having adjudicated various Madoff liquidation matters, this Court's familiarity with the background of this matter is presumed.

B. SIPA Authorizes the Trustee to Pursue Avoidance Actions

SIPA § 78fff(b) grants the Trustee authority to conduct a SIPA liquidation proceeding "in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." SIPA § 78fff(b); *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 231 (2d Cir. 2011) (the "*Second Circuit Net Equity Decision*") ("Pursuant to SIPA, Mr. Picard has the general powers of a bankruptcy trustee, as well as additional duties, specified by the Act, related to recovering and distributing customer property.") (citing SIPA § 78fff-1). SIPA § 78fff-1(b) expressly incorporates the Bankruptcy Code and authorizes a SIPA Trustee to recover any fraudulent transfers, including those to customers. SIPA § 78fff-1(b); *Second Circuit Net Equity Decision*, 654 F.3d at 242 n.10 ("SIPA and the Code intersect to . . . grant a SIPA trustee the power to avoid fraudulent transfers for the benefit of customers.") (quoting *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122, 136 (Bankr. S.D.N.Y. 2010) (the "*Net Equity Decision*").

C. The Trustee's Avoidance Action Against The Defendants

The Trustee's complaint in the Legacy Capital Action alleges eight bankruptcy causes of action, all "core" matters arising under the Bankruptcy Code or the New York Fraudulent Conveyance Act (New York Debtor and Creditor Law § 270 *et seq.* (McKinney 2001)

("DCL")).[8] *See* Warshavsky Decl. at Exhibit 1. Specifically, the Trustee seeks to avoid certain transfers as (i) actual fraudulent transfers under Bankruptcy Code sections 548(a)(1)(A), 550(a), and 551 and the DCL and (ii) constructive fraudulent transfers under Bankruptcy Code sections 544, 548(a)(1)(B), 550(a), and 551 and the DCL.

ARGUMENT

I. **THE DEFENDANTS' MOTIONS TO WITHDRAW THE AVOIDANCE ACTION CANNOT MEET THE REQUIREMENTS FOR MANDATORY WITHDRAWAL**

The Defendants contend that this Court must withdraw the reference pursuant to section 157(d), but do not and cannot demonstrate any of the exceptional circumstances required for mandatory withdrawal. Rather, the Legacy Capital Action requires nothing more than adjudication of core avoidance actions under the Bankruptcy Code to recover customer property. In pursuing these bankruptcy claims against the Defendants, the Trustee is not violating SIPA.[9] Rather, SIPA expressly authorizes the Trustee to avoid transfers that are void and voidable pursuant to title 11. There is no exception in SIPA that precludes avoidance of transfers to customers; to the contrary, the recovery of transfers "to or on behalf of customers" is expressly contemplated in SIPA § 78fff-2(c)(3).

The Second Circuit recently confirmed that a SIPA trustee is conferred with the ability to pursue fraudulent transfer actions on behalf of customers. *Second Circuit Net Equity Decision,*

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[8] Pursuant to a stipulation dated October 28, 2011, the Trustee agreed to voluntarily dismiss without prejudice the unjust enrichment claim asserted against certain of the Defendants. A copy of the stipulation is annexed to the Warshavsky Decl. at Exhibit 2. Accordingly, the Trustee does not respond to the Defendants' arguments concerning his standing to pursue common law claims and treats those arguments as withdrawn. *See* Legacy Capital Motion at 13, n.10.

[9] *See* Background, Section B *supra*. The Second Circuit noted "[a] SIPA liquidation is a hybrid proceeding" and that a SIPA trustee is conferred with the general powers of a bankruptcy trustee, as well as additional duties, including the ability to pursue fraudulent transfer actions on behalf of customers. *Second Circuit Net Equity Decision*, 654 F.3d at 231, 242 n. 10.

654 F.3d at 231, 242 n. 10. Courts uniformly have held that a trustee may sue customers in SIPA cases for fraudulent transfers. *See, e.g., Picard v. Taylor (In re Park South Sec., LLC)*, 326 B.R. 505, 512-13 (Bankr. S.D.N.Y. 2005) (holding that the trustee had standing to bring fraudulent transfer claims against customers); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 496 (S.D.N.Y. 2001) (affirming bankruptcy court's judgment that fraudulent transfers to customers were avoidable); *see also SIPC v. S.J. Salmon*, No. 72 Civ. 560, 1973 U. S. Dist. LEXIS 15606, at *31 (S.D.N.Y. Aug. 8, 1973) ("SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stockbroker-debtors in SIPA proceedings.").

In fact, the Trustee is pursuing his avoidance claims so that the salutary purposes of the statute may be affected. *See Second Circuit Net Equity Decision*, 654 F.3d at 242 n. 10. (Second Circuit noting that "in the context of this Ponzi scheme – the Net Investment Method is nonetheless more harmonious with provisions of the Bankruptcy Code that allow a trustee to avoid transfers made with the intent to defraud, *see* 11 U.S.C. § 548(a)(1)(A), and 'avoid[s] placing some claims unfairly ahead of others,' *In re Adler, Coleman Clearing Corp*., 263 B.R. 406, 463 (Bankr. S.D.N.Y. 2001)."). None of these issues, however, require withdrawal of the reference as there is no conflict between title 11 and other federal non-bankruptcy laws. They merely require the application of such laws.

A. Section 157(d) Has Been Narrowly Construed in the Second Circuit

The scope of bankruptcy jurisdiction over all matters affecting a debtor and its property is broadly construed. *Shugrue v. Airline Pilots Ass'n, Int'l* (*In re Ionosphere Clubs, Inc.*), 922 F.2d 984, 994 (2d Cir. 1990). All cases and proceedings arising under, arising in, or related to a bankruptcy case, including SIPA liquidations, are automatically referred to the bankruptcy court. *See* 28 U.S.C. § 157(a). For the bankruptcy court to proceed efficiently and within the bounds of

its broad grant of jurisdiction, the reference to the bankruptcy court may be withdrawn only in limited circumstances, as provided in section 157(d) of title 28. *In re Ionosphere Clubs, Inc.*, 922 F.2d. at 993. The Second Circuit has consistently held that section 157(d) must be "construed narrowly," *see, e.g., id.* at 995, and is not to be used as an "escape hatch through which most bankruptcy matters [could] be removed to a district court." *Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, 343 B.R. 63, 66 (S.D.N.Y. 2006) (quoting *Carter Day Indust., Inc. v. EPA (In re Combustion Equip. Assoc.)*, 67 B.R. 709, 711 (S.D.N.Y. 1986)) (internal quotation omitted). A narrow reading of the mandatory withdrawal provisions is necessary so as not to "eviscerate much of the work of the bankruptcy courts." *Houbigant, Inc. v. ACB Mercantile, Inc. (In re Houbigant, Inc.)*, 185 B.R. 680, 683 (S.D.N.Y. 1995).

Mandatory withdrawal "is not available merely because non-Bankruptcy Code federal statutes will be considered in the bankruptcy court proceeding." *In re Ionosphere Clubs, Inc.*, 922 F.2d at 995. Rather, as the Second Circuit has held, mandatory withdrawal "is reserved for cases where *substantial and material consideration* of non-Bankruptcy Code federal statutes is necessary for the resolution of the proceeding." *Id.* at 995 (emphasis added). "Substantial and material consideration" requires a bankruptcy judge to "engage in significant interpretation, as opposed to simple application, of federal laws apart from the bankruptcy statutes." *City of New York v. Exxon Corp.*, 932 F.2d 1020, 1026 (2d Cir. 1991); *Enron Corp. v. J.P. Morgan Sec.* (*In re Enron Corp.*), 388 B.R. 131, 136 (S.D.N.Y. 2008). Indeed, the "substantial and material consideration" standard excludes from mandatory withdrawal those cases that involve only the routine application of non-title 11 federal statutes to a particular set of facts. *See In re Johns-Manville Corp.*, 63 B.R. 600, 602 (S.D.N.Y. 1986).

The Defendants cannot meet the standard for withdrawal of the reference to resolve the

Trustee's claims because no material interpretation of non-bankruptcy federal statutes is required to resolve the issues at hand, nor is there any potential conflict between the Bankruptcy Code and other non-bankruptcy federal statutes. On its face, SIPA mandates removal to the bankruptcy court in the first instance. SIPA is routinely interpreted by bankruptcy courts, as it was originally derived from a bankruptcy statute and specifically incorporates the Bankruptcy Code. The Defendants' allegation that SIPA cannot be analyzed and applied by the bankruptcy court is simply wrong, as evidenced by, *inter alia*, the *Net Equity Decision* and the Second Circuit's affirmance thereof.

B. *Stern v. Marshall* Does Not Require or Otherwise Warrant Withdrawal

The Defendants attempt to argue that the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011) is cause for withdrawal. In their Motion, the Defendants strain to draw a parallel between the Trustee's traditional avoidance action under the Bankruptcy Code and the counterclaim addressed by the *Stern* Court. The Defendants argue that the bankruptcy court here would somehow be limited and could not issue a final judgment in the Legacy Capital Action. *See* Legacy Capital Motion at 15-16, BNP Paribas Motion at 8-9. Not so. The Defendants wildly misconstrue *Stern*'s "narrow" ruling which makes clear that it does not "meaningfully change[ ] the division of labor" between bankruptcy courts and district courts. *Stern*, 131 S. Ct. at 2620.

Stern did not involve straightforward bankruptcy law claims for avoidance of fraudulent transfers, but instead concerned a creditor's claim for defamation and a state law counterclaim by the debtor for tortious interference. *Stern* did not interpret 28 U.S.C. § 157(b)(2)(H), which identifies as core proceedings those that "determine, avoid or recover fraudulent conveyances."

The Defendants' effort to relate these two completely distinct matters fails. *Stern* neither holds nor even suggests that actions seeking to avoid and recover fraudulent transfers are not

properly the province of and rightly decided by non-Article III judges. As recently recognized by this district:

> *Stern* is replete with language emphasizing that the ruling should be limited to the unique circumstances of that case, and the ruling does not remove from the bankruptcy court its jurisdiction over matters directly related to the estate that can be finally decided in connection with restructuring debtor and creditor relations. . . .

In re Salander O'Reilly Galleries, 453 B.R. 106, 115-16 (Bankr. S.D.N.Y. July 18, 2011). *See, e.g., Stern*, 131 S. Ct. at 2611 ("Here Vickie's claim is a state law action independent of the federal bankruptcy law"); *id.* at 2620 ("We do not think the removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute . . . the question presented here is a 'narrow' one"); *Kirschner v. Agoglia (In re Refco Inc.*), 461 B.R. 181 (Bankr. S.D.N.Y. 2011) ("Clearly several of [the Court's] rationales argue that *Stern* does not preclude the bankruptcy court from issuing a final judgment on a fraudulent transfer claim."). Indeed, courts considering *Stern* have routinely declined to give it the expansive scope that the Defendants request.[10]

In contrast to the state law tortious interference counterclaim at issue in *Stern*, the Trustee

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[10] *See In re Safety Harbor Resort & Spa*, 456 B.R. 703, 717 (Bankr. M.D. Fla. 2011) (finding that a bankruptcy court has jurisdiction to hear fraudulent transfer claims and "that nothing has changed" as a result of *Stern*); *In re Custom Contractors, LLC*, 2011 WL 6046397, at *6 (Bankr. S.D. Fla. Dec. 5, 2011) (This Court's job is [to apply *Stern*'s holding,] not to extend *Stern*) to fraudulent transfer actions based on Supreme Court *dicta*, and in so doing, upend the division of labor between district and bankruptcy courts that has been in effect for nearly thirty years."); *In re Extended Stay, Inc.,* 2011 WL 5532258, at *6 ("Withdrawing the reference simply due to the uncertainty caused by *Stern* is a drastic remedy that would hamper judicial efficiency on the basis of a narrow defect in the current statutory regime identified by *Stern*."); *Field v. Lindell (In re The Mortgage Store, Inc.)*, 2011 WL 5056990, at *6–7 (D. Haw. Oct. 5, 2011) (determining not to withdraw the reference even if *Stern* applied to fraudulent transfer proceeding because "[w]ithdrawal of the reference at this stage would result in this court losing the benefit of the bankruptcy court's experience in both the law and the facts, resulting in an inefficient allocation of judicial resources"). *See also In re Ambac Fin. Grp., Inc.*, 57 B.R. 299, 308 (Bankr. S.D.N.Y. 2011); *In re Olde Prairie Block Owner, LLC*, 457 B.R. 692, 698 (Bankr. N.D. Ill. 2011); *In re Am. Bus. Fin. Servs., Inc.*, 457 B.R. 314, 319-320 (Bankr. D. Del. 2011).

has brought traditional avoidance actions against the Defendants that the Bankruptcy Code specifically and exclusively authorizes bankruptcy trustees to pursue under Bankruptcy Code sections 544, 547 and 548. *See, e.g.*, *Walker, Truesdell, Roth & Assocs. v. The Blackstone Group, L.P. (In re Extended Stay, Inc.)*, 2011 WL 5532258, at *7-8 (S.D.N.Y. Nov. 10, 2011); *Kelley v. JPMorgan Chase & Co., et al.,* 2011 WL 4403289, at *6 (D. Minn. Sept. 21, 2011); *Michigan State Hous. Dev. Auth. v. Lehman Brothers*, No. 11 Civ. 3392 (JGK) (S.D.N.Y., Sept. 14, 2011). In short, *Stern* is fairly read as limited to state law counterclaims with no relationship to federal bankruptcy law. *Id*. at 2611.

Despite the narrow holding of *Stern*, the Defendants claim the bankruptcy court cannot finally determine fraudulent conveyance claims like those asserted in the Complaint. *See* Legacy Capital Motion at 15-16, BNP Paribas Motion at 8-9. Such a sweeping interpretation of *Stern* is inconsistent with the decision itself, would deprive district courts of bankruptcy courts' specialized expertise to handle such claims, and would have the practical effect of eliminating bankruptcy courts permanently.

As Chief Justice Roberts observed, the bankruptcy court's specialized expertise was not needed in the adjudication of the common law tort counterclaim addressed in *Stern*. *See Stern,* 131 S. Ct. at 2615 ("The 'experts' in the federal system at resolving common law counterclaims such as Vickie's are the Article III courts, and it is with those courts that her claim must stay."). However, specialized bankruptcy expertise is critical to the efficient administration of fraudulent transfer actions brought under the Bankruptcy Code, especially in this case where the bankruptcy court is administering over 1,000 related cases and thousands of objections.

The importance of this particularized framework utilizing the bankruptcy court's expertise is magnified in a Ponzi scheme case, such as this case, where the majority of the

debtor's assets were fraudulently transferred to third parties before BLMIS's bankruptcy, resulting in the transferees receiving money stolen from other investors. As a consequence, the bankruptcy court must manage both the allowance of claims to those who were defrauded as well as recovery of fraudulent transfers in order to pay the allowed claims. This distinctive relationship is succinctly set forth in Judge Drain's *Refco* opinion:

> Since the enactment of the Bankruptcy Code, the management and determination of statutory avoidance claims has been a primary function of the bankruptcy courts. Such claims often play a prominent role in bankruptcy cases, either because of their sheer numbers or because of the effect that the potential avoidance of a transfer, lien, or obligation may have on creditors' recoveries. This is particularly so in cases where most, if not all, of the debtor's estate was transferred to third parties pre-bankruptcy, such as the many Ponzi-scheme driven cases of recent years, requiring a coordinated response overseen by one judge on behalf of a host of creditor-victims. The ability to manage efficiently the investigation and litigation of such claims, and their possible global settlement, decreases if handled on a piecemeal basis by different judges no matter how talented.

In re Refco Inc., 461 B.R. at 188.

Judge Drain emphasizes the necessity of maintaining ties between the avoidance action against the Defendants and BLMIS's claims allowance process. It further makes clear the difference between *Stern's* treatment of a generic state law tort counterclaim, which was "in no way derived from or dependent upon bankruptcy law," but rather was "a state law tort action that exists without regard to any bankruptcy proceeding" *(Stern,* 131 S. Ct. at 2618)), and the Trustee's avoidance actions which "flow from a federal statutory scheme" and are "completely dependent upon adjudication of a claim created by federal law." *Id.* at 187 (quoting *Stern,* 131 S. Ct. at 2614) (concluding that bankruptcy courts have constitutional power to issue final judgments in fraudulent transfer actions even where the defendant had not filed a proof of claim in the bankruptcy).

Even if the bankruptcy court did not have constitutional authority to enter a final judgment on fraudulent transfer claims, which it does, withdrawal is not warranted based on the clear mandate set forth in the recently entered Amended Standing Order of Reference, which provides:

> If a bankruptcy judge or district judge determines that entry of a final order or judgment by a bankruptcy judge would not be consistent with Article III of the United States Constitution in a particular proceeding referred under this order and determined to be a core matter, the bankruptcy judge *shall* . . . hear the proceeding and submit proposed findings of fact and conclusions of law to the district court.

Amended Standing Order of Reference, *In the Matter of Standing Order of Reference Re: Title 11*, 12 Misc. 00032 (S.D.N.Y. Feb. 2, 2012) (emphasis added). In light of this directive, a Court in this District recognized that this "explicit authority to issue proposed findings and conclusions in connection with core matters that are found to fall within the *Stern* holding[]" dictated maintaining the reference to the bankruptcy court. *See* Opinion & Order, *Adelphia Recovery Trust v. FLP Group, Inc.*, No. 11 Civ. 06847 (PAC) (S.D.N.Y. Jan. 30, 2012) at 10 (denying a motion to withdraw the reference predicated on *Stern* and the issue of whether a bankruptcy court may adjudicate fraudulent transfer claims to final judgment). As such, the bankruptcy court is required to hear the Legacy Capital Action pursuant to the Amended Standing Order of Reference, and if it is later determined that entry of a final judgment by the bankruptcy court would be inconsistent with Article III, then this Court may treat such judgment as proposed findings of fact and conclusions of law. *See id.*[11]

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[11] In addition, the Local Rules Committee for the United States Bankruptcy Court for the Southern District of New York has proposed certain new Local Bankruptcy Rules as of February 21, 2012—all of which require parties in adversary proceedings to affirmatively state in responsive pleadings whether the pleader consents to the entry of final orders or judgment by the bankruptcy court. These proposed rules further establish that the bankruptcy court should preside over core proceedings and leave the determination of whether the bankruptcy court may enter a

C. Interpretation of the Extraterritoriality of SIPA and the Bankruptcy Code Does Not Warrant Mandatory Withdrawal

Defendants also assert that pursuant to the Supreme Court ruling in *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010) withdrawal is needed to determine whether SIPA and the Bankruptcy Code have extraterritorial reach. *See* Legacy Capital Motion at 14. However, there is no "substantial and material" interpretation of non-bankruptcy federal law in the present case which warrants mandatory withdrawal. Indeed, Defendants are asking how *Morrison* applies, if at all, to the Trustee's claims under the Bankruptcy Code.

Morrison dealt with the extraterritorial application of the 1934 Exchange Act, and more specifically with Australian nationals who invested in an Australian company, which traded on an Australian exchange. The present case is a SIPA liquidation in the United States based on fraudulent business transactions that took place in New York, involved sophisticated entities—such as the Defendants—that either invested directly with BLMIS or invested in feeder funds that were largely established for the sole purpose of investing with BLMIS. There is no apparent reason—and certainly no good reason—why the Trustee cannot recover the initial or subsequent transfers of fraudulent and/or preferential transfers of customer property to the Defendants simply because Legacy Capital and Montpellier are incorporated outside the United States.

Defendants are also wrong when asserting that SIPA has no clear indication of an extraterritorial application and that this is an issue of "first impression" requiring mandatory withdrawal. *See* Legacy Capital Motion at 14. SIPA specifically and expressly incorporates the Bankruptcy Code making applicable almost all of the liquidation provisions that apply to ordinary bankruptcy liquidations. And those provisions, which include the power to avoid and

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final judgment until the case is fully determined. *See Proposed New Local Bankruptcy Rules,* UNITED STATES BANKRUPTCY COURT, SOUTHERN DISTRICT OF NEW YORK, http://www.nysb.uscourts.gov/localrules2012.html (last visited February 24, 2012).

recover fraudulent transfers and preferences, may be applied both in the United States and beyond. *See Picard v. Chais*, 440 B.R. 274, 281 (Bankr. S.D.N.Y. 2010) (stating "[t]he United States has a strong interest in applying the provisions of the Bankruptcy Code" and holding that the exercise of personal jurisdiction over a foreign defendant was reasonable since the Trustee's claims arise under U.S. bankruptcy laws and are brought on behalf of all creditors and customers in this SIPA proceeding).

In fact, both the plain language and congressional intent underlying the Bankruptcy Code make it clear the Code does in fact have clear and unmistakable extraterritorial application. While drafting the Bankruptcy Code, Congress expressly recognized that a debtor's assets and interests would sometimes lie outside of the United States. Indeed, section 541(a) of the Bankruptcy Code explicitly states that the commencement of a bankruptcy case creates an estate comprised of property "wherever located and by whomever held," 11 U.S.C. § 541(a) (emphasis added).

Section 541(a) echoes the worldwide jurisdictional language of 28 U.S.C. § 1334(e)(1), which states that "the district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction of all the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate." *See Deak & Co., Inc. v. Jr. R.M.P. Soedjono (In re Deak & Co., Inc.)*, 63 B.R. 422, 427 (Bankr. S.D.N.Y. 1986) ("Congress inserted this language to 'make clear that a trustee in bankruptcy is vested with the title of the bankrupt in property which is located without, as well as within, the United States.'"); *In re Rajapakse*, 346 B.R. 233 (Bankr. N.D. Ga. 2005); *Diaz-Barba v. Kismet Acquisition, LLC*, 2010 WL 2079738, at *10 (S.D. Cal. May 20, 2010) (noting the court may exercise jurisdiction over all property of the bankrupt estate, even if located outside the United States, because the provisions of the Code as

they relate to property of the estate apply extraterritorially). *See also French v. Liebmann (In re French)*, 440 F.3d 145, 152 (4th Cir. 2005) (holding that since section 548 allows the avoidance of transfers of the debtor in property "wherever located," the presumption against extraterritoriality did not prevent the use of the court's avoidance powers).[12] The Trustee has the right, ability and fiduciary obligation to pursue property of the estate, wherever it is located, including from Defendants.

Defendants' *Morrison* argument ignores the two-sided process involved in bankruptcy and SIPA proceedings. In effect, Defendants argue the Bankruptcy Code's avoidance and recovery provisions cannot be applied to Defendants simply because they are based outside the United States. If this Court accepts Defendants' argument, the result would be that no foreign national could make a claim in a bankruptcy or SIPA proceeding pending in the United States. Such an absurd result was never intended by Congress nor has it ever been countenanced by a court in this country.

In short, Defendants' *Morrison* argument fails to provide any justification for mandatory withdrawal of the reference. Bankruptcy courts are called upon by the Bankruptcy Code to hear and determine cases seeking the recovery of property wherever it is found. The fact that certain Defendants have foreign status is nothing unique. The bankruptcy court is fully empowered to hear these cases and there is no material and substantial issue of federal non-bankruptcy law

[12] Case law also demonstrates that the automatic stay under section 362 of the Code, which is one of the fundamental debtor protections provided by bankruptcy laws, applies extraterritorially. *Nakash v. Zur (In re Nakash)*, 190 B.R. 763, 768 (Bankr. S.D.N.Y. 1996) (finding that the stay exists to protect the estate from "a chaotic and uncontrolled scramble for the Debtor's assets in a variety of uncoordinated proceedings in different courts."); *Picard v. Maxam Absolute Return Fund, L.P. (In re Bernard L. Madoff Inv. Sec. LLC),* 460 B.R. 106, 114 (Bankr. S.D.N.Y. 2011) (finding "that based upon the applicable Code sections, other indicia of congressional intent and case law in this district, the automatic stay applies extraterritorially.") (quoting *In re Nakash*, 190 B.R. at 768)).

requiring the withdrawal of the reference. As a result, under *Morrison*, there is no basis for mandatory withdrawal.

D. <u>Interpretation of Section 546(e) of the Bankruptcy Code Does Not Warrant Mandatory Withdrawal</u>

The Defendants assert that the Court should withdraw the reference because the Trustee and SIPC are interpreting Bankruptcy Code section 546(e) in a manner that conflicts with SIPA. *See* Legacy Capital Motion at 11-12, BNP Paribas Motion at 6-7. However, withdrawal of the reference is not appropriate as to this issue because its resolution involves only straightforward application and interpretation of Bankruptcy Code provisions.[13] This issue presents no interpretive or complicated issues of first impression under non-title 11 federal laws, nor do the Defendants try to assert one.

As indicated above, the Defendants are not innocent bystanders to Madoff's Ponzi scheme, and thus the application of section 546(e) is at least a question of fact—not a question of law. Indeed, applying it to the particularly egregious facts of this case demonstrates the injustice that would result—insulating some of the earliest contributors to the fraud from liability. The

[13] The Trustee continues to preserve and assert his position that the mere invocation of Bankruptcy Code section 546(e) by defendants, such as the Defendants here, does not provide a proper basis for mandatory withdrawal of the reference. Likewise, the Trustee reasserts his position that the same section of the Bankruptcy Code is inapplicable here, notwithstanding this Court's ruling in *Picard v. Katz*, No. 11 Civ. 3605, 2011 WL 4448638 at *2-3 (S.D.N.Y. Sept. 27, 2011). No other court has found that section 546(e) provides a basis for mandatory withdrawal of the reference under 28 U.S.C. § 157(d) , *see In re Extended Stay, Inc.*, 2011 WL 5532258, at *7, or that section 546(e) is properly extended to fictional transactions pursuant to a Ponzi scheme. *See, e.g.*, *See Johnson v. Neilson (In re Slatkin)*, 525 F.3d 805, 819 (9th Cir. 2008); *Kipperman v. Circle Trust F.B.O. (In re Grafton Partners)*, 321 B.R. 527, 541 (9th Cir. BAP 2005) (applying section 546(e) to payments made in connection with a Ponzi scheme "would amount to an absurd contradiction of the securities laws"); *Wider v. Wooton*, 907 F.2d 570, 573 (5th Cir. 1990) (rejecting application of section 546(e) defense in a Ponzi scheme context so as not to "implicitly authorize fraudulent business practices through an unjustified extension of the stockbroker defense"); *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec. LLC)*, 2011 WL 3897970, at *12 (S.D.N.Y. Aug. 31, 2011); *In re Bernard L. Madoff Inv. Sec. LLC*, 458 B.R. 87, 116-17 (Bankr. S.D.N.Y. 2011).

Defendants, given their level of financial sophistication, cannot credibly maintain that they were unaware of the numerous red flags contrary to industry standards, including questions about Madoff's reported options volume, Madoff's unorthodox fee structure, and the lack of transparency and secretive nature of Madoff's investment operations. There are other indicia of fraud discussed in the complaint, but these alone demonstrate that the Defendants received fraudulent transfers in the face of various indicia that BLMIS was not engaged in legitimate securities trading and show that the Defendants cannot assert that there is not, at the very least, a factual issue as to whether they could have reasonably believed that BLMIS was engaged in legitimate trading activity.

Moreover, in a recent case in this district, the Court found that the application of an affirmative defense under section 546(e) did not warrant mandatory withdrawal of the reference. *In re Extended Stay, Inc*., 2011 WL 5532258, at *7. In particular, the *In re Extended Stay* court noted that the issue of whether or not section 546(e) of the Bankruptcy Code precluded certain claims under the Fair Debt Collections Practices Act or certain securities laws could not overcome "the 'narrow' scope this Circuit gives to mandatory withdrawal under section 157(d)" because the movants failed to point to any federal statute requiring "significant interpretation" rather than mere application to a particular set of facts. *Id.* (citations omitted).

Finally, the Defendants urge that the "securities laws" or "non-bankruptcy laws" must be considered in connection with the application of section 546(e). Yet, the Defendants have not pointed to a single securities law at issue. In fact, in support of their argument, the Defendants cited to no statute other than Bankruptcy Code section 546(e), which *explicitly refers* to definitions in the Bankruptcy Code itself. *See* Legacy Capital Motion at 11-12, BNP Paribas Motion at 6. Simply put—and as demonstrated in the Defendants' moving papers—no

additional law needs to be interpreted outside of the Bankruptcy Code. As such, the determination of whether and how Bankruptcy Code section 546(e) should be applied requires only simple interpretation and application of the Bankruptcy Code. Accordingly, mere application of title 11 is not a basis for mandatory withdrawal of the reference to the bankruptcy court pursuant to 28 U.S.C. § 157(d).

E. The Bankruptcy Court's Interpretation of Bankruptcy Code Section 548(c) Does Not Warrant Mandatory Withdrawal

Attempting to exempt themselves from the fraudulent conveyance laws and their obligation to demonstrate good faith to retain the fraudulent transfers they received from Madoff, the Defendants claim that the Court must withdraw the reference to determine what they characterize as the Trustee's novel interpretation of SIPA to retroactively impose a due diligence obligation on brokerage customers. *See* Legacy Capital Motion at 8-11. The Defendants' attempt to manufacture a conflict between the Bankruptcy Code and SIPA wholly misses the mark. First, the Defendants are not innocent investors, but rather are sophisticated and professional financial institutions, feeder funds, and investors. Second, any due diligence obligation that the Defendants had upon becoming aware of facts that imputed inquiry notice of Madoff's fraud has nothing at all to do with any interpretation of SIPA or other non-bankruptcy federal law.

Rather, the Defendants' due diligence (or, in this case, lack thereof) is relevant only in the context of whether the Defendants can establish a good faith defense to the Trustee's avoidance claims under section 548(c) of the Bankruptcy Code and analogous state fraudulent conveyance laws. It is *not* a pleading requirement. *See* Memorandum Opinion and Order, *In re Bayou Group, LLC, et al.*, No. 09 Civ. 02340 (PGG) (S.D.N.Y. Feb. 06, 2012) at 14 (ECF No. 65) (finding that defendants failed to establish their good faith under section 548(c) and failed to

meet their "burden at trial to demonstrate that a diligent investigation would not have led to discovery of the fraud. . ."). As such an analysis requires nothing more than a straight-forward application of the Bankruptcy Code itself, as well as established case law interpreting the good faith defense under the Bankruptcy Code.

F. Withdrawal Would Impede Judicial Efficiency and Uniform Administration of the SIPA Bankruptcy Proceeding

Finally, the bankruptcy court has been administering this SIPA bankruptcy proceeding for over three years. Judicial economy would only be promoted by allowing the specialized bankruptcy court, already familiar with the extensive record and proceedings in the BLMIS case, to initially adjudicate the Legacy Capital Action. *See In re Wedtech Corp.*, 94 B.R. at 296; *In re Laventhol & Horwath*, 139 B.R. 109, 116 (S.D.N.Y.1992). It is the more efficient and appropriate course, as "[a]llowing the bankruptcy courts to consider complex questions of bankruptcy law before they come to the district court for *de novo* review promotes a more uniform application of bankruptcy law." *In re Extended Stay, Inc.*, 2011 WL 5532258 at *10 (finding that preserving bankruptcy court's ability to determine claims that implicated section 546(e) of the Bankruptcy Code weighed against withdrawal of the reference).

CONCLUSION

For the foregoing reasons, the Trustee respectfully requests the court deny the Motions.

Date: New York, New York
February 24, 2012

/s/ Oren J. Warshavsky

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
Oren J. Warshavsky
Email: owarshavsky@bakerlaw.com
Nicholas J. Cremona
Email: ncremona@bakerlaw.com
Anat Maytal
Email: amaytal@bakerlaw.com

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