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for the Substantively Consolidated SIPA Liquidation  
of Bernard L. Madoff Investment Securities LLC  
and the estate of Bernard L. Madoff*

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

SECURITIES INVESTOR PROTECTION  
CORPORATION,

Plaintiff-Applicant,

v.

BERNARD L. MADOFF INVESTMENT  
SECURITIES LLC,

Defendant.

No. 08-01789 (SMB)

SIPA LIQUIDATION

(Substantively Consolidated)

In re:

BERNARD L. MADOFF,

Debtor.

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

Plaintiff,

v.

FRANK J. AVELLINO, et al.,

Defendants.

Adv. Pro. No. 10-05421 (SMB)

**TRUSTEE'S REPLY IN FURTHER SUPPORT OF  
MOTION TO REARGUE THE COURT'S ORDER  
GRANTING IN PART AND DENYING IN PART MOTION TO DISMISS**

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Irving H. Picard (the “Trustee” or “SIPA Trustee”), as trustee for the substantively consolidated liquidation of the business of Bernard L. Madoff Investment Securities LLC (“BLMIS”) and the estate of Bernard L. Madoff (“Madoff”), under the Securities Investor Protection Act (“SIPA”),<sup>1</sup> 15 U.S.C. §§ 78aaa-III, by and through his undersigned counsel, respectfully submits this reply in further support of his Memorandum of Law in Support of his Motion to Reargue the Court’s Order Granting in Part and Denying in Part Motion to Dismiss pursuant to Local Bankruptcy Rule 9023-1(a), (ECF No. 125) (“Motion to Reargue”).<sup>2</sup>

### **PRELIMINARY STATEMENT**

The Motion to Reargue established that the Trustee meets the standard for reargument because: (i) the July 21 Decision<sup>3</sup> overlooked that pursuant to the express provisions of SIPA, the Protective Decree entered by the District Court created a SIPA liquidation proceeding and appointed the SIPA Trustee with authority over the *business* Madoff operated as the broker-dealer-member of SIPC; (ii) the July 21 Decision overlooked that the Substantive Consolidation Order’s *nunc pro tunc* effect and express provisions specifically provided the SIPA Trustee with authority to recover customer property fraudulently transferred by both BLMIS and Madoff; and (iii) reargument is warranted to prevent the inequitable treatment of the customers of the consolidated estate.<sup>4</sup>

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<sup>1</sup> References to SIPA sections hereinafter shall replace “15 U.S.C.” with “SIPA.”

<sup>2</sup> Unless otherwise described, capitalized terms shall have the same meaning given to them in the Motion to Reargue.

<sup>3</sup> *Picard v. Avellino (In re Bernard L. Madoff Inv. Sec. LLC)*, Adv. Pro. No. 10-05421, 2016 WL 4040799 (SMB) (Bankr. S.D.N.Y. July 21, 2016) (the “July 21 Decision”).

<sup>4</sup> This last point is not, as Defendants assert, a new argument, but rather merely lays out the facts that demonstrate that the Trustee meets the standards governing motions to reargue. (Motion to Reargue at 4 and 15). Nonetheless, this Court can exercise its discretion to grant reargument to prevent manifest injustice, even if a new argument is raised. *Hightower v. Nassau Cty. Sheriff’s Dep’t*, 343 F. Supp. 2d 191, 193 (E.D.N.Y. 2004) (“[A] court has discretion to reconsider an issue not initially raised in order to correct a clear error or prevent manifest injustice.”)

Notably, Defendants do not challenge the Trustee’s point that the express language of paragraph 7 of the Substantive Consolidation Order specifically authorized the SIPA Trustee to recover customer property fraudulently conveyed by *both* BLMIS and Madoff.<sup>5</sup> Instead, Defendants focus their energies on attacking the legitimacy of the entire Substantive Consolidation Order, asserting that the Bankruptcy Court did not have the authority to issue such an order conjoining Madoff as a debtor in the SIPA liquidation proceeding.<sup>6</sup>

Defendants essentially argue that in SIPA liquidation proceedings, the bankruptcy courts are without authority to enter orders substantively consolidating non-SIPA debtors with SIPA debtors, claiming that such an order would involve a bankruptcy court impermissibly attempting to modify the substance of an order by a “superior court”—in this case, the Protective Decree issued by the District Court.<sup>7</sup> (Defendants’ Opposition at 9). But it has long been recognized that bankruptcy courts possess the power to substantively consolidate non-debtors into a debtor’s bankruptcy estate. And the express language of SIPA, the Protective Decree and the Bankruptcy Code all make clear that the Bankruptcy Court had this same authority and power in this

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(citation and internal quotation marks omitted); *Henderson v. Metro. Bank & Trust Co.*, 502 F. Supp. 2d 372, 379 (S.D.N.Y. 2007) (granting reconsideration where a new argument was raised because it could “effect a manifest injustice”) (internal quotation marks omitted).

<sup>5</sup> Paragraph 7 of the Substantive Consolidation Order states:

All powers, rights, claims and interests of the SIPA Trustee and the BLMIS estate are expressly preserved, including without limitation all Chapter 5 and Chapter 7 powers, rights, claims and/or interests, and the SIPA Trustee is authorized to pursue claims on behalf of the consolidated estate as the representative of and fiduciary for the BLMIS SIPA Proceeding and as subrogee and assignee of creditors’ claims for, among other things, the avoidance and recovery of transferred property.

<sup>6</sup> Memorandum of Law in Opposition to the Trustee’s Motion to Reargue the Court’s Order Granting in Part and Denying in Part Motion to Dismiss (ECF No. 129) (“Defendants’ Opposition”) at 6–9.

<sup>7</sup> Indeed, Defendants mistakenly state that the Court “ruled that subject matter jurisdiction was lacking.” (Defendants’ Opposition at 8).

proceeding to enter an Order substantively consolidating a non-SIPA debtor into a SIPA liquidation proceeding.

Defendants more specifically challenge the Court's authority to enter paragraph 7 of the Substantive Consolidation Order (Defendants' Opposition at 9), which expressly provided that the SIPA Trustee was authorized to recover customer property that had been fraudulently transferred by *both* BLMIS and Madoff. But the Court's Order did not create or assign any powers to recover "customer property" that the trustees did not already possess by Congressional statute. As set forth below, the SIPA Trustee had the power to pursue customer property fraudulently conveyed by BLMIS pursuant to the Protective Decree and SIPA.<sup>8</sup> And the Chapter 7 Trustee, Alan Nisselson, was authorized by Section 749 of the Stockbroker Liquidation provisions of the Bankruptcy Code, 11 U.S.C. § 749(a), to recover "customer property" fraudulently transferred by Madoff as a stockbroker. Paragraph 7 of the Substantive Consolidation Order merely specified that the SIPA Trustee should exercise those statutory powers to recover customer property upon substantive consolidation of the Madoff estate into the SIPA liquidation proceeding.

Finally, Defendants' entire attack on the Bankruptcy Court's jurisdiction and authority to enter the Substantive Consolidation Order overlooks the fact that the SIPA Trustee's authority to pursue customer property conveyed by BLMIS and Madoff flows from the Protective Decree entered by the District Court—which created a SIPA liquidation proceeding and appointed Mr. Picard as SIPA trustee for the "business" operated by Madoff as the broker-dealer member of SIPC—regardless of the form that business may have taken.

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<sup>8</sup> For all the reasons set forth in the Motion to Reargue, the SIPA Trustee had the power to recover customer property fraudulently conveyed by both BLMIS and Madoff. (Motion to Reargue at 5–8).

## ARGUMENT

### **I. THE BANKRUPTCY COURT HAD THE AUTHORITY TO ENTER THE SUBSTANTIVE CONSOLIDATION ORDER**

#### **A. SIPA, the Protective Decree, the Bankruptcy Code and Bankruptcy Law all Conferred the Bankruptcy Court with Authority to Enter Its Order Substantively Consolidating the Madoff Estate Into the SIPA Liquidation**

Pursuant to SIPA § 78eee(b)(4), upon the District Court's issuance of the Protective Decree, the liquidation proceeding was removed to this Court, which thereafter was deemed to possess all of the jurisdiction and powers of the District Court:

Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, under this section, *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. The latter court shall thereupon have *all of the jurisdiction, powers, and duties conferred by this chapter upon the court* to which application for the issuance of the protective decree was made.<sup>9</sup>

Once removed to the Bankruptcy Court, SIPA liquidation proceedings are to be conducted pursuant to title 11 of the United States Code—the Bankruptcy Code.<sup>10</sup> And it has long been recognized that under section 105 of the Code, the bankruptcy courts have the power to substantively consolidate debtor estates. *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 n.1 (2d Cir. 1988). Notably, courts have repeatedly recognized the bankruptcy court's authority to substantively consolidate non-debtor entities with debtors, and to issue such orders *nunc pro tunc* for the express purpose of retroactively extending a trustee's authority to recover

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<sup>9</sup> SIPA § 78eee(b)(4) (emphasis added).

<sup>10</sup> SIPA § 78fff(b) provides that “[t]o the extent consistent with [SIPA], a liquidation proceeding shall be conducted 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.”

fraudulent conveyances made by the former non-debtor entities. See *In re Bonham*, 229 F.3d 750, 763–65 (9th Cir. 2000) and cases cited therein.

Contrary to Defendants’ arguments, the fact that this is a SIPA liquidation proceeding does not alter this Court’s authority to enter orders of substantive consolidation. This is demonstrated by the decisions of several bankruptcy courts, which granted substantive consolidation of non-SIPA debtors into SIPA liquidation proceedings.<sup>11</sup> *Matter of Lewellyn*, 26 B.R. 246, 252–53 (Bankr. S.D. Iowa 1982) (ordering substantive consolidation of individual’s estate with SIPA debtor entity where the evidence showed that the principal totally disregarded the corporate fictions and formalities); Order at ¶¶ 6, C, *In re Park South Sec., LLC*, Adv. Pro. No. 03-8024A (RDD) (Bankr. S.D.N.Y. Sept. 10, 2003) (attached as Exhibit A to SIPC Ltr., Aug. 12, 2015 (“SIPC Letter”), ECF No. 103-1 (bankruptcy court substantively consolidated SIPA debtor with non-SIPC debtor affiliate, where both entities were perpetrating a fraud); Order at ¶¶ 2, B, *In re Donahue Sec., Inc.*, Adv. Pro. No. 01-1027 (JPH) (Bankr. S.D. Ohio. Nov. 29, 2001) (attached as Exhibit C to SIPC Letter, ECF No. 103-3) (bankruptcy court substantively consolidated SIPA debtor with non-SIPC debtor, where both entities conducted the fraudulent scheme).

Therefore, pursuant to SIPA and chapter 11, this Court had jurisdiction and authority over the estates of the two debtors being liquidated before it: Madoff and BLMIS,<sup>12</sup> and the express authority to exercise its equitable powers to enter the Substantive Consolidation Order

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<sup>11</sup> To the extent that Defendants challenge the Bankruptcy Court’s constitutional authority to enter orders of substantive consolidation (Defendants’ Opposition at 5 n.6), such arguments have been rejected by the courts. *In re LLS Am., LLC*, No. 09-06194-PCW11, 2011 WL 4005447, at \*3 (Bankr. E.D. Wash. Sept. 8, 2011), *Yaquinto v. Ward (In re Ward)*, Adv. Pro. No. 15-3037-BJH, 2016 WL 4691049, at \*4 (Bankr. N.D. Tex. Sept. 7, 2016).

<sup>12</sup> Madoff was in fact a debtor already under the jurisdiction of this Court by virtue of the involuntary petition that commenced the chapter 7 estate.

*nunc pro tunc* conjoining Madoff as a debtor in this SIPA liquidation proceeding. (Motion to Reargue at 9–12 (citations omitted)). As a result of that Order, the SIPA Trustee is authorized pursuant to SIPA § 78fff-2(c)(3) to recover customer property fraudulently transferred by both BLMIS and Madoff.

**B. The Bankruptcy Court Did Not Exceed Its Authority By Specifying in the Substantive Consolidation Order that the SIPA Trustee Was Authorized to Recover Customer Property Fraudulently Transferred by Both BLMIS and Madoff**

Contrary to Defendants’ arguments, the Court did not exceed its authority in paragraph 7 of the Substantive Consolidation Order by specifying that the SIPA Trustee has the authority to recover customer property fraudulently transferred by both BLMIS and Madoff. (Defendants’ Opposition at 7–9). In fact, *both* trustees were already authorized by Congressional statutes to recover “customer property;” and this Court’s Substantive Consolidation Order merely clarified that the SIPA Trustee should exercise those statutory powers upon substantive consolidation.

SIPA § 78fff-2(c)(3) fully authorizes the SIPA Trustee to recover fraudulent transfers of customer property made by BLMIS. At the same time, Section 749 of the Bankruptcy Code—the Stockbroker Liquidation provisions of chapter 7—authorized the Chapter 7 Trustee, Alan Nisselson, to recover voidable transfers of “customer property” fraudulently conveyed by Madoff as a stockbroker. 11 U.S.C. § 749(a) (“[A]ny transfer of property that, but for such transfer, would have been customer property, may be avoided by the [chapter 7] trustee . . .”).<sup>13</sup>

As previously noted in the Motion to Reargue, the parties and the Court anticipated the potential for overlapping claims to recover fraudulent transfers of customer property that were

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<sup>13</sup> In the involuntary petition commencing Madoff’s chapter 7 proceeding, in the “Nature of Business” section on page 1, “Stockbroker” is checked. Involuntary Petition at 1, *In re Bernard L. Madoff*, Case No. 09-11893(SMB) (Bankr.S.D.N.Y. Apr. 13, 2009), ECF No.1.

made by both BLMIS and Madoff. (Motion to Reargue at 13). Thus, paragraph 7 of the Substantive Consolidation Order specified that, upon substantive consolidation, the SIPA Trustee was authorized to recover customer property fraudulently transferred by both BLMIS and Madoff. (Motion to Reargue at 13). As this provision was not attempting to authorize statutory powers that the trustees did not already possess under SIPA and the Bankruptcy Code, paragraph 7 of the Substantive Consolidation Order was a valid exercise of this Court's substantive consolidation powers.

Assuming, *arguendo*, that the Court were to nevertheless conclude that it did not have the authority in the Substantive Consolidation Order to authorize the SIPA Trustee to recover customer property fraudulently transferred by Madoff's business while it was operated as a sole proprietorship and that only the Chapter 7 Trustee has that authority under Section 749 of the Code, the SIPA Trustee respectfully reiterates his request for leave to amend the pleadings formally to add the Chapter 7 Trustee as a plaintiff. (*See Fokas Ltr.* at 6 n.6, Aug. 12, 2015, ECF No. 102 (citations omitted)).

## **II. DEFENDANTS' ARGUMENT CONCERNING THE BANKRUPTCY COURT'S SUBSTANTIVE CONSOLIDATION ORDER OVERLOOKS THE DISTRICT COURT'S PROTECTIVE DECREE**

Defendants' entire argument concerning the Bankruptcy Court's jurisdiction and authority to enter the Substantive Consolidation Order (Defendants' Opposition at 7-9) overlooks the fact that the SIPA Trustee's authority to pursue customer property fraudulently transferred by BLMIS and Madoff flows from the Protective Decree entered by the District Court.

As noted in the Motion to Reargue, at all times, there was only one registered broker-dealer "member" of SIPC that Madoff operated, and it was this "member" for which SIPC filed an application for a protective decree. (Motion to Reargue at 5). The Protective Decree issued by the District Court specifically appointed Mr. Picard the SIPA Trustee for the "business"

operated by that broker-dealer member of SIPC—and unlike the Bankruptcy Code’s provisions concerning “debtors,” SIPA’s express provisions concerning debtors look solely to the “member,” not what business form that SIPC member may have taken over time. (Motion to Reargue at 5–8).

Accordingly, pursuant to the Protective Decree and SIPA §78fff-2(c)(3), the SIPA Trustee has the authority to recover fraudulent transfers of customer property made by Madoff’s broker-dealer business, when it was organized as a limited liability company and when it was organized as a sole proprietorship.

**CONCLUSION**

For the reasons set forth above and in the Motion to Reargue, the Trustee respectfully requests that the Court grant the Motion to Reargue.

Date: October 3, 2016  
New York, New York

By: /s/ David J. Sheehan

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