UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	SIPA LIQUIDATION No. 08-01789 (BRL) Substantively Consolidated
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. JPMORGAN CHASE & CO., JPMORGAN CHASE BANK, N.A., J.P. MORGAN SECURITIES LLC, and J.P. MORGAN SECURITIES LTD., Defendants.	Adv. Pro. No. 10-4932 (BRL) Case No. 1:11-cv-00913 (CM) (MHD)

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

Third-Party Plaintiff,

v.

JPMORGAN CHASE & CO., JPMORGAN CHASE BANK, N.A., J.P. MORGAN SECURITIES LLC, and J.P. MORGAN SECURITIES LTD.,

Third-Party Defendants.

TRUSTEE'S MEMORANDUM OF LAW IN OPPOSITION TO MOTION TO DISMISS

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Irving H. Picard ("Trustee"), as trustee for the substantively consolidated liquidation of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") under the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa, *et seq*. ("SIPA"), and the estate of Bernard L. Madoff, by and through his undersigned counsel, respectfully submits this memorandum of law in opposition to the motion of JPMorgan Chase & Co., JPMorgan Chase Bank, N.A., J.P. Morgan Securities LLC, and J.P. Morgan Securities Ltd. (collectively, "JPMC" or "Defendants") to dismiss the Trustee's Amended Complaint.

PRELIMINARY STATEMENT

In perpetrating the largest Ponzi scheme in history, Bernard L. Madoff did not act alone. As is well known, he had a cadre of employees and other insiders that assisted him in committing this pernicious, decades-long, multi-billion-dollar fraud. But Madoff could not have conducted a Ponzi scheme of this magnitude solely within the four corners of BLMIS. Instead, he needed a bank that was willing to assist in the daily operation of a Ponzi scheme on an unprecedented scale: to routinely enable billions of dollars to bounce back and forth between BLMIS and its customers with an evident lack of legitimate business purpose, to overlook the lack of securities trading, to decline to inquire into or report fictitious account activity, and to cloak the whole enterprise in the respectability of a renowned financial institution. And for decades, Madoff conducted his fraud through a single account (the "703 Account") at JPMC.

JPMC could not have been more integral to the fraud perpetrated by Madoff. It was his longtime banker, facilitating millions of transactions for which there was no legitimate business purpose. JPMC was also the banker to other key defendants that were part of Madoff's inner circle and profited handsomely from Madoff's scheme—including Norman Levy and Sterling Equities—and as such facilitated evidently fraudulent transactions not only within the 703 Account, but also between the 703 Account and other high-profile accounts at JPMC.

But its role in this fraud was not limited to the mere provision of banking services, however crucial that role was to the propagation of Madoff's scheme. JPMC also was a lender, a leverage provider, and a direct investor in some of the largest BLMIS feeder funds, in each role strategically pumping hundreds of millions of dollars into the Ponzi scheme. With one of the world's most prestigious investment banking divisions, it created complex, structured financial products based on the fictitious returns of BLMIS. JPMC did all of this despite knowing that Madoff's account was not used for securities trading and BLMIS's returns could not be explained or replicated. In fact, JPMC openly surmised that "there is a well-known cloud over the head of Madoff and that his returns are speculated to be part of a Ponzi scheme." (Am. Compl. ¶ 119.) But JPMC engaged in a cost-benefit analysis of the effect on JPMC of a fraud at BLMIS and concluded that any fraud would have to exceed $3 billion to impact JPMC's bottom line. JPMC continued its investment until it determined it was too risky to continue any longer. At that time, JPMC quietly redeemed its own funds from BLMIS but left the funds of its investors exposed to the financial devastation that occurred when the world learned what JPMC already knew: Madoff was a fraud.

Despite its twenty-plus years and inextricable role in the fraud perpetrated by Madoff, JPMC now seeks to distance itself from the fraud by disclaiming knowledge—at the pleading stage—of the very facts contained in its own books and records, facts that it must know in order to run its business and that it is required to know by law. JPMC calculated the amounts in the 703 Account every day when it swept those amounts into its own coffers to earn money on them, and approved checks and wires for billions of dollars to and from its own institution. Moreover, financial institutions, especially those as large as JPMC, are governed by an array of statutes and regulations, as well as their own internal policies, all of which are designed to uncover fraud.

JPMC has extensive internal procedures relating to the provision of banking services and corresponding reporting mechanisms, including, for example, anti-money laundering monitoring systems, policies relating to the handling and reporting of cash and wire transactions, "know-your-customer" rules, and other risk prevention policies, policies that JPMC was required by a consent order with state and federal regulators to improve after it was implicated in the Enron fraud. This combination of governmental regulation and internal compliance policies is intended to prevent individuals or entities from using the United States banking system to operate, continue, and legitimatize fraud.

JPMC agrees that these systems and policies are designed to ensure compliance with relevant law and were in place during the time period at issue. The Trustee's Amended Complaint alleges, down to individual transactions, that the activity in BLMIS's account evidenced massive fraud implicating those systems and laws. Remarkably, JPMC does not dispute the conclusion that these transactions were facially illegitimate, nor does it refute that its monitoring and reporting were deficient as to BLMIS. To the contrary, JPMC relies on its apparent failure to observe these laws to shield its own conduct.

For example, JPMC states that although the "Amended Complaint alleges that certain transactions '*should* have prompted a check-fraud investigation, which *would* have revealed more suspicious behavior,' the Amended Complaint does not allege that [JPMC] ever took steps that actually uncovered Madoff's fraud." (Def. Br. 39) (citing Am. Compl. ¶ 249(e) (emphasis in Def. Br.).) But the Trustee alleges that JPMC knew that the 703 Account was being used for fraudulent activity. The allegations about what JPMC "should have" done are based on the allegations of the facts JPMC *actually knew*, and what the law required JPMC to have done based on that actual knowledge.

Similarly, the law and JPMC's own internal policies mandate that JPMC "know its customers" to ensure that the bank is not being utilized in the commission of criminal or fraudulent activity, and must perform additional diligence in connection with extending credit and structuring financial products. But not only was JPMC *required* to know Madoff, it had before it specific documents, transactions and information that demonstrated the fraudulent nature of BLMIS. For example, the JPMC commercial banking division employee responsible for "knowing" the customer acknowledged receipt of reports that BLMIS was required to submit to the SEC ("FOCUS Reports") for its use in regulating broker-dealers. These reports were reviewed by JPMC. They contained false material financial information about BLMIS, such as the amount of loans and funds it held. JPMC's defense, again, is that "there is no allegation that anyone at JPMC noticed or drew negative inferences from" the lies in the FOCUS Reports. (Def. Br. 39 n.8.) But that is exactly the point: having received and reviewed these reports, it was JPMC's obligation to "notice" that they contained lies and to draw "negative inferences" from them.

JPMC attempts to insulate itself from being charged with actual knowledge of its own records, and later its own "diligence" into BLMIS, by relying on its failure to investigate and report that knowledge. This is the very definition of conscious avoidance. It does not matter, as JPMC urges, whether anyone "deliberately compromised" or "disabled" JPMC's compliance and reporting procedures specifically to help Madoff. The existence of these laws and policies is evidence of what JPMC was required to do with the knowledge it had, not evidence of what JPMC knew. The reasons that JPMC failed to comply with obligations based on its knowledge are of no import.

Moreover, contrary to JPMC's assertion that there is no allegation that Madoff would have been "unable to obtain routine services from another bank," (Def. Br. 51), another financial institution that observed similar activity in a Madoff account—on a far smaller scale and over a shorter period of time—shut the account down. Those fraudulent transactions occurred between that bank's Madoff account and a Madoff account at JPMC, making them equally as visible to JPMC—but JPMC did nothing. (Am. Compl. ¶ 5.) Thus, it is far from clear that Madoff would have been able to obtain such services from another bank. It is equally unreasonable to assume that any other bank also would wantonly ignore its legal obligations. Had Madoff maintained his account at a bank other than JPMC that was performing its duties as required by law, this fraud would have been uncovered or ceased far sooner.

JPMC's view is that it cannot be held liable unless a plaintiff has direct evidence—at the pleading stage—of JPMC's subjective knowledge of the specific contours of the fraud, even when JPMC fails to comply with governing federal and state laws designed to prevent fraud and criminal activity, even when fraud occurs, and even when the plaintiff has pled facts sufficient to show JPMC's actual knowledge of fraud as a matter of law. JPMC believes it should avoid liability stemming from a fraud by stating that it may not have complied with the statutory and regulatory schemes in place to uncover fraud—even though such failures to comply only lead to fraud in the first place. Such is not the law, and such circular reasoning should not be countenanced.

The heart of JPMC's defense is that it is not plausible that it would deliberately engage in fraud in order to profit from routine banking services. This defense has served it well in fraud after fraud. But there was nothing routine about the scope and length of the Ponzi scheme that Madoff was able to perpetrate with JPMC's assistance—which was conducted through daily, multimillion dollar fictitious transactions over a span of decades—or the services JPMC provided to Madoff and the web of other central Madoff investors who were also key JPMC customers. If JPMC is permitted to rely on the "routine banking services" defense here, the result will be a virtual immunity for banks that assist fraud on an institutional level—and a powerful disincentive to follow the laws and policies that require banks to investigate and know their customers.

To credit such a defense would be to forever insulate banks from the direct and foreseeable harm that flows from conduct such as that engaged in by JPMC here. As between JPMC and innocent BLMIS customers, JPMC was undoubtedly in the best position to detect the fraudulent scheme. Innocent investors had no access to Madoff's banking records. They could not conduct the sort of due diligence that a global bank like JPMC did. But JPMC had unparalleled access to the inner workings of BLMIS such that it could have put a stop to the fraud at any time. JPMC knew facts plainly indicative of a fraud that it was required by law to detect, investigate, and report. What it did is a fact issue, and one that Madoff's victims should be entitled to learn.

That this is the correct legal result on a motion to dismiss is clear because whether JPMC had knowledge of a fraud is an inherently factual issue. Yet it is also the only equitable result. Innocent BLMIS customers did not deposit their funds in a small savings and loan bank in Queens when they invested with Madoff; they deposited their funds with JPMC, a preeminent global bank. In the absence of the specific knowledge available and known to JPMC—and unknowable by them—these customers relied on the American banking system and financial markets, and the statutory and regulatory schemes that support those systems—the very laws that

JPMC suggests it did not adhere to. JPMC should not be permitted to ignore laws, regulations, rules, and codes of conduct without consequence.

Joint tortfeasors that have actual knowledge of a fraud, that enable a fraud, and know that their actions cause harm must be held accountable. The injury that JPMC, as Madoff's joint tortfeasor, caused to innocent customers was not merely foreseeable, it was inevitable. And having serviced the 703 Account for decades, through which all of the fraudulent monies flowed, JPMC's conduct harmed all of Madoff's customers and creditors in the same way. Because of this generalized nature of the injuries, the Trustee has exclusive standing to bring these claims under Second Circuit precedent. But the Trustee does not bring this action to benefit himself, nor does he bring it as a private prosecutor. Rather, he brings it to benefit the thousands of innocent victims of Madoff's fraud, just as the law, including SIPA and the Bankruptcy Code, contemplates. Allowing JPMC and others to escape liability for their knowing and devastating conduct would be to give a free pass to the bank to the direct detriment of Madoff's victims and in direct contravention of the law. The Amended Complaint should stand.

SUMMARY OF ARGUMENT

JPMC's arguments seeking dismissal of the Trustee's complaint are meritless. The baseless attacks on the sufficiency of the Trustee's pleading ignore the Trustee's detailed allegations set forth in the Amended Complaint. JPMC tries to hamstring the Trustee by asserting preemption arguments, which have no applicability to any of the issues in this case. But JPMC's most aggressive attempt to escape liability is premised on the argument that the Trustee lacks standing to assert the claims brought herein. Not surprisingly, JPMC urges this Court to adopt the Opinion and Order of the Honorable Jed S. Rakoff in *Picard v. HSBC Bank, plc*, *et al.*, Case Nos. 11-CV-763 (JSR) and 11-CV-836 (JSR), 2011 WL 3200298 (S.D.N.Y. July 28, 2011) (the "*HSBC* decision"). The *HSBC* court held that the Trustee did not have standing to bring common law claims against the defendants in that action. Without arguing the Trustee's appeal in this case, the Trustee respectfully submits that the *HSBC* decision is unsound in multiple respects and should not be followed by this Court. Further, even if the Court were to accept the *Wagoner* rule and apply the *in pari delicto* doctrine to a SIPA trustee, the *HSBC* decision remains incorrect and does not consider the additional standing arguments made here. As is demonstrated herein, the Trustee has standing to bring claims and this case should proceed for the benefit of all BLMIS victims and the general estate.

The Trustee's standing to bring his claims against JPMC rests on multiple grounds. Whether as a joint tortfeasor seeking contribution, a bailee of the fund of customer property under SIPA, an assignee of SIPC's subrogation rights, or as a hypothetical judgment creditor under Section 544(a) of the Bankruptcy Code, the Trustee may seek to hold JPMC responsible for allowing the Ponzi scheme to aggregate to billions of dollars. The Trustee's claims assert generalized harm to *all* creditors of the BLMIS estate. Realistically, due to the potential bar of class actions under SLUSA and the sheer difficulty for an individual BLMIS customer to bring a claim against JPMC, if the Trustee cannot bring these claims, nobody can. Furthermore, given the generalized nature of the injury, Second Circuit authority dictates that *only* the Trustee can bring these claims. And regardless of whether the Trustee has standing as a bailee, subrogee, or creditor, he has the right to step into the shoes of the debtor and seek contribution from JPMC. The Court should therefore apply the principles of SIPA and the Bankruptcy Code in recognizing the Trustee's standing.

The ability to bring common law claims is consistent with both the statutory construction of SIPA and its principal purpose, which is "to protect investors against financial losses arising from the insolvency of their brokers," *In re New Times Sec. Servs., Inc.*, 463 F.3d 125, 127 (2d

Cir. 2006) ("*New Times II*") (internal quotation marks omitted). SIPA is also intended to "protect capital markets by instilling confidence in securities traders." *Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1317 (2d Cir. 1976). In deciding *HSBC*, the *HSBC* court mistakenly focused on specific provisions of SIPA to demonstrate that it does not explicitly grant the Trustee standing to bring common law claims. The *HSBC* court's interpretation of the statute, which it deemed "cabined by Title 11," 2011 WL 3200298, at *3, is in direct contravention of both the plain language and purpose of SIPA.

A SIPA liquidation is a hybrid proceeding that proceeds in accordance with, and as though conducted under, Title 11 "[t]o the extent consistent with the provisions of" SIPA. 15 U.S.C. § 78fff-1(a); § 78fff(b); *In re Bernard L. Madoff Inv. Secs. LLC*, 2011 WL 3568936, at *12 n.10 (2d Cir. Aug. 16, 2011) (noting the "hybrid" nature of a SIPA proceeding). In other words, in addition to the powers and responsibilities of an ordinary bankruptcy trustee under Title 11, a SIPA trustee has even greater powers granted by SIPA. *See* 15 U.S.C. § 78fff-1(a), (b)(1) (requiring a SIPA trustee to deliver securities "to the maximum extent practicable in satisfaction of customer claims."); *SEC v. Albert & Maguire Sec. Co.*, 560 F.2d 569, 574 (3d Cir. 1977); *Bondy v. Chem. Bank*, No. 74 Civ. 3515, 1975 WL 435, at *3 (S.D.N.Y. Oct. 30, 1975) ("The SIPA trustee thus has broad, wide-ranging powers to complete the liquidation of the state [sic]."); *Gold v. Hyman*, No. 72 Civ. 5431, 1975 WL 374, at *2 (S.D.N.Y. Apr. 1, 1975) (a SIPA trustee has "even more powers in some circumstances than a trustee in bankruptcy").

No law or policy dictates that a SIPA trustee is in a weaker position than a non-SIPA bankruptcy trustee, who has the right to sue third parties for damages. Rather, SIPA's statutory scheme fully anticipates and recognizes that the Trustee shall be armed with a full range of powers, including the ability to sue for damages and hold tortfeasors such as JPMC accountable for the damages they have caused to the fund of customer property and the BLMIS estate. As the Third Circuit explained in *Albert & Maguire Sec. Co.*, 560 F.2d at 574, the authority of a trustee "to recover from third parties for the benefit of the customer fund had been established" in section 60e of the Bankruptcy Act of 1898 by amendments adopted in the Chandler Act of 1938.

In the absence of an ability to sue for damages, the Trustee would be foreclosed from creating a general estate, the creation of which is contemplated by the statute. In failing to acknowledge SIPA's hybrid nature and the additional powers afforded to a SIPA trustee, the *HSBC* court thus ignored the duality of the Trustee's duties to both the estate under Title 11 and SIPA, and to BLMIS customers under SIPA, as recognized by the Second Circuit in *Rosenman Family, LLC v. Picard*, 395 F. App'x 766, 768 (2d Cir. 2010). In *Rosenman*, the Second Circuit found that "SIPA liquidations involve two kinds of claimants: customers and general unsecured creditors," and that customer claims "are satisfied from a *customer property estate*, which is separate from the general estate used to satisfy the claims of general unsecured creditors." *Id.* (citing *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 270 (Bankr. S.D.N.Y. 1996) (emphasis added)). In fact, customer property does not become part of the debtor's general estate until all customers' net equity claims are satisfied; until then, the claims of general creditors are subordinated to claims of customers. *See Holmes v. SIPC*, 503 U.S. 258, 262 n.1. The distinction and separation between the two estates—which makes sense in light of SIPA's goals of protecting customers and instilling confidence in the securities markets—is nowhere mentioned in the *HSBC* decision and runs counter to the *HSBC* court's decision to limit SIPA merely to its explicit language.

Even accepting, *arguendo*, the proposition that SIPA does not expressly provide a trustee with the ability to bring common law claims, such a power should have been found under Title 11. But after noting that the Trustee's powers were "cabined" by Title 11, the *HSBC* court disregarded those Title 11 powers and declared that "the only provision in SIPA that actually discusses how the Trustee is permitted to go about recovering customer property provides the Trustee with the authority to bring avoidance claims, not common law claims." 2011 WL 3200298, at *4. This statement, however, is belied by myriad cases in which courts have recognized the authority of other bankruptcy trustees to bring common law claims. *See, e.g.*, *Tese-Milner v. Beeler (In re Hampton Hotel Investors, L.P.)*, 289 B.R. 563 (Bankr. S.D.N.Y. 2003) (aiding and abetting breach of fiduciary duty).

Moreover, Title 11 provides the Trustee with an explicit basis to bring these claims under Section 544(a). As a so-called hypothetical judgment creditor, the Trustee has standing to sue third parties for common law claims so long as those claims could be brought under New York law. Such claims are permitted under the plain language of Section 544(a), which provides the Trustee with statutory standing and authority to assert claims against third parties in certain circumstances, including those that exist herein. The Second Circuit's *Wagoner* rule and the doctrine of *in pari delicto* do not apply to the Trustee as a hypothetical judgment creditor. In that capacity, the Trustee stands in the shoes of an innocent creditor, and can bring New York law claims like those he brings here.

In addition to New York claims that he may bring as a hypothetical judgment creditor, as successor-in-interest to BLMIS, the Trustee is authorized under New York law to seek contribution from JPMC for its share of the liability caused to the BLMIS estate. A SIPA trustee has all of the powers of a trustee under Title 11, and a trustee under Title 11 may bring state law claims for the benefit of the estate, including the power to sue and be sued and the ability to bring causes in action and claims by the debtor against others. 15 U.S.C. § 78fff-1(b); 11 U.S.C. § 323; 11 U.S.C. § 541(a)(1). Moreover, this claim for contribution is made without any regard to any *in pari delicto* defense, as contribution necessarily requires the parties to be *in pari delicto*. There is no standing issue with respect to this claim.

The *HSBC* court's rejection of standing based on contribution because the "Trustee is not subject to 'liability for damages' in the sense contemplated by New York's contribution statute," 2011 WL 3200298, at *10, is conclusory and not supported by any citation. The opinion does not analyze New York's contribution statute or explain why it does not apply. A review of the New York contribution law demonstrates that it does not take into consideration how liability arises; in fact, joint tortfeasors can have all types of liability—statutory, strict, common law—and still be entitled to contribution. *See* N.Y. C.P.L.R. 1401.

Similarly misplaced was the *HSBC* court's application of federal preemption in ruling that "[g]iven that these payments [for customer claims] are being made pursuant to a comprehensive statutory scheme . . ., the Trustee cannot rely on state law to seek contribution where a right to contribution is not expressly provided by a federal statute." 2011 WL 3200298, at *10. Federal courts assume that a federal statute has not supplanted state law unless congressional intent is "clear and manifest." *See, e.g.*, *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 541-542 (2001).

In the absence of Congress's expressed intent to preempt state law, courts will recognize preemption only (1) where the scheme of federal regulation is "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it," *Gade v. Nat'l Solid Wastes Mgmt. Ass'n*, 505 U.S. 88, 98 (1992) (quoting *Fidelity Fed. Sav. & Loan*

Ass'n v. De la Cuesta, 458 U.S. 141 (1982)), and (2) where "compliance with both federal and state regulations is a physical impossibility," *id.* (quoting *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963)), or where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). Here, SIPA has no limitation on the Trustee's common law rights and compliance with both SIPA and New York contribution law is more than feasible. In fact, the Trustee's ability to seek contribution is consistent with the purpose of SIPA that has a goal of maximizing recovery for the benefit of customers.

The logic and reasoning of the *HSBC* decision ignores this clear statutory mandate of SIPA and assumes, wrongly, that there are other parties to bring such claims. The *HSBC* decision urges that claims for generalized injuries can be brought by individual creditors, and places heavy emphasis on the case of *Caplin v. Marine Midland Grace Trust of New York*, 406 U.S. 416 (1972), which held that a bankruptcy trustee does not have standing to sue third parties for fraud on behalf of *individual* creditors. *Id.* at 558. Yet the *HSBC* court did not consider the corollary—which is that a Trustee does have standing to bring claims for generalized injuries. To that end, the *HSBC* court failed to consider the Second Circuit's opinion in *St. Paul Fire & Marine, Inc. v. PepsiCo, Inc.*, 884 F.2d 688 (2d Cir. 1989), which explained that trustees may sue for general claims that will benefit the entirety of the estate: "If a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by a creditor of the debtor, the trustee is the proper person to assert the claim." *Id.* at 701. Clearly, the Trustee is not bringing claims on behalf of a particular creditor or group of creditors—either here or in the *HSBC* action. Rather, the Trustee is doing precisely what the Second Circuit deemed permissible in *St. Paul*: bringing general claims that will benefit *all* creditors. Although the *HSBC* court acknowledged this aim by the Trustee, it ignored the *St. Paul* decision in finding that the Trustee was precluded from so doing.

Moreover, under the Second Circuit's holding and rationale in *Redington v. Touche Ross & Co.*, 592 F.2d 617 (2d Cir. 1978), *rev'd on other grounds*, 442 U.S. 560 (1979), a trustee is empowered to bring common law claims against third parties as a bailee of the fund of customer property; SIPC, as subrogee, succeeds to the rights of customers for whom it has advanced funds. 592 F.2d at 624. As such, the Trustee and SIPC have standing to bring claims against any third party who caused these losses. *Redington* is consistent both with SIPA and the common law of bailment, based on the Trustee's exclusive possession of the fund of customer property, and as a representative of the general estate. In addition, the Trustee may pursue assignments from creditors pursuant to Section 541(a)(7) of the Bankruptcy Code in accordance with the decision of *Bankr. Servs. Inc. v. Ernst & Young LLP* (*In re CBI Holding Co., Inc.*), 529 F.3d 432 (2d Cir. 2008).

At the outset, the *HSBC* court ruled that the Supreme Court's reversal on other grounds without reaching the standing issue means that the "secondary holding of *Redington* is no longer good law. 2011 WL 2300298, at *7. Such a statement overlooks Second Circuit pronouncements to the contrary, as well as over thirty years of case law since *Redington*. In *SIPC v. BDO Seidman, LLP*, 222 F.3d 63 (2d Cir. 2000), the Second Circuit quoted *Redington* for the proposition that a SIPA trustee could sue "*any wrongdoer whom [the customers] could sue themselves*." *Id.* at 71 (quoting *Redington*, 592 F.2d at 625) (emphasis added). The Second Circuit reiterated that a "SIPA trustee acts as a bailee of the customers' property, and, in an effort to 'marshal[ ] and return[ ]' that property, may sue any third party responsible for the customers' losses." *Id.* at 71 (citing *Redington*, 592 F.2d at 625). In fact, although the Second Circuit was asked to overturn *Redington*, Justice (then Judge) Sotomayor expressly declined and explained that that "this court is bound by a decision of a prior panel unless and until its rationale is overruled, implicitly or expressly, by the Supreme Court or this Court *en banc*." *Id.* at 69 (quoting *Bank Boston, N.A. v. Sokolowski* (*In re Sokolowski*), 205 F.3d, 532, 534–35 (2d Cir. 2000)).

Despite the Second Circuit's confirmation of *Redington's* precedential value and other courts' adherence to the decision, the *HSBC* court relied on the dicta of a district judge's opinion in *Mishkin v. Peat, Marwick, Mitchell & Co.*,744 F. Supp. 531 (S.D.N.Y. 1990)—a case that is factually inapposite—as it never reviewed or ruled on a trustee's authority to sue as bailee on behalf of a fund of customer property—and considered to be an outlier. *See Appleton v. First Nat'l Bank of Ohio*, 62 F.3d 791, 799-800 (6th Cir. 1995) (remarking that *Mishkin* "departed from the precedent of its circuit."). As further detailed in Point III.A.3.C below, the *HSBC* decision also omitted the numerous cases within the Second Circuit and elsewhere that have acknowledged the precedent set by *Redington. See Giddens v. D.H. Blair & Co. (In re A.R. Baron & Co.)*, 280 B.R. 794, 805 (Bankr. S.D.N.Y. 2002) ("Under the Second Circuit's decision in *Redington*, a SIPC trustee may maintain an action as bailee on behalf of customers of an insolvent broker-dealer who have not been fully reimbursed by SIPC."); *Picard v. Taylor (In re Park S. Sec., LLC)*, 326 B.R. 505, 515-17 (Bankr. S.D.N.Y. 2005) (acknowledging that court was "bound" by *Redington*'s holding with respect to SIPC's standing as subrogee); *SIPC v. Cheshier & Fuller, L.L.P. (In re Sunpoint Secs., Inc.)*, 377 B.R. 513, 550 (Bankr. E.D. Tex. 2007) (trustee had standing as bailee and subrogee); *Lutz v. Chitwood (In re Lutz)*, 337 B.R. 160, 162 (Bankr. S.D. Ohio 2005) ("[t]here is no dispute" that a SIPA trustee has standing to assert SIPC's subrogation claims and may assert claims as a bailee of customer property); *Lutz v. Chitwood (In* *re Donahue Sec., Inc.),* 318 B.R. 667, 670 (Bankr. S.D. Ohio, 2004). Even Chief Judge Preska, who was critical of the decision, nevertheless held that she was bound to follow *Redington* with respect to both subrogation and bailment. *SIPC v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 654 (S.D.N.Y. 1999). The Supreme Court also has implicitly acknowledged the binding effect of *Redington*. *See Holmes*, 503 U.S. at 271 n.17.

The *HSBC* court's substantive rejection of *Redington* similarly misses the mark. The *HSBC* decision strains to find factual differences between the *HSBC* case and the circumstances in *Redington*. For instance, in distinguishing *Redington* from the circumstances of BLMIS, the *HSBC* decision notes that *Redington* involved a breach of a regulatory duty by an accountant while the bailed property was in the broker-dealer's possession, as opposed to the case against the *HSBC* defendants in which there was no duty to the debtor and the "immediate consequence of the defendants' alleged breach was to cause a gain in the value of the bailment, rather than a loss." 2011 WL 3200298, at *8. Not only is this a distinction without a difference, but to surmise that the "value of the bailment" actually gained value at some point in the circumstances of BLMIS ignores the plain fact that Madoff was running a Ponzi scheme. Moreover, in rejecting the possibility of the Trustee's standing based on assignment, the *HSBC* court ignored the Second Circuit's holding to the contrary in *In re CBI Holding Co., Inc.*, 529 F.3d at 456–59, which specifically held that a bankruptcy trustee has standing to sue as an assignee.

Finally, the *HSBC* decision states that *Redington's* holding that SIPC is equitably subrogated to the rights of customers for whom it advances payment "was in the context of SIPA as it stood at the time" and that SIPA was subsequently amended so that "the priority scheme enacted post-*Redington* forecloses the possibility that SIPC can be subrogated to customer claims against third parties." 2011 WL 3200298, at *8. This conclusion is not supportable, and does not make sense in light of either *Redington*'s holding or SIPA's subsequent amendments. Under SIPA, both currently and at the time of *Redington*, SIPC makes payments to customers for losses of their customer property, which includes property that may have been "unlawfully converted." 15 U.S.C. § 78*lll*(4). Under the common law doctrine of equitable subrogation, SIPC becomes subrogated to the customers who receive advances from SIPC with respect to claims based on those losses. As the Second Circuit opined in *Redington*, "it is more in keeping with the intent of Congress that wrongdoers not receive a windfall benefit from the existence of SIPC, and that SIPC be able to recoup its losses from solvent wrongdoers." *Redington*, 592 F.2d at 624.

At the time of *Redington*, § 78fff(f)(1) of SIPA expressly limited SIPC's subrogation rights to "customer's claims against the debtor's . . . estate." Following *Redington*, however, Congress amended SIPA to clarify that SIPC's rights against the estate are not its exclusive remedy. SIPA was modified in 1978 to provide that SIPC's subrogation rights against the debtor's estate are "*in addition to all other rights it may have at law or in equity* . . . ."[1] 15 U.S.C. § 78fff-3(a) (emphasis added). There is simply nothing in this amendment, which broadens SIPC's rights, to support the *HSBC* court's assertion that the statute "forecloses the possibility that SIPC can be subrogated to customer claims against third parties." 2011 WL 320098, at *8. Contrary to the *HSBC* court's conclusion, this provision was actually amended to be *consistent* with *Redington*. *See Appleton*, 62 F.3d at 799 (6th Cir. 1995) (noting that the amended language of the statute "further supports the conclusions reached in" *Redington*). The expansion of the SIPA trustee's powers in the amendments contradicts the *HSBC* court's determination that Congress intended to limit *Redington*'s holding.

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[1] Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 1978 H.R. 8331 (1978).

Another perceived bar to the Trustee's claims is the affirmative defense of *in pari delicto* and the related *Wagoner* rule. However, the affirmative defense of *in pari delicto* has no application to any of the causes of action brought here. Parties are necessarily *in pari* delicto on a contribution claim, and *in pari delicto* does not apply to the Trustee's standing as a judgment creditor or as bailee or assignee of SIPC's subrogation rights.

Even if the *Wagoner* rule were relevant, it should not apply here. The underpinnings behind the doctrine—that a bad actor or wrongdoer such as Madoff not benefit from his wrongs through a claim for damages against another wrongdoer—is entirely inapposite in the context of this case. Madoff is currently serving 150 years in a federal prison and does not stand to benefit in any way should the Trustee recover here. Nor does the Trustee stand to gain from any judgment obtained. Rather, the only beneficiaries of the Trustee's suit against third party wrongdoers are the very victims who were defrauded. The requested application of *in pari delicto* and the *Wagoner* rule by JPMC—the very bank that facilitated the laundering of billions of dollars to the foreseeable detriment of BLMIS victims—is antithetical to the principles of equity and fundamental fairness. Moreover, it would make no sense to foreclose actions against third party tortfeasors based on fraud or malfeasance of a bankrupt's principals when the law allows the same actions if the bankrupt's principals were merely negligent or incompetent. JPMC should not be permitted to use this doctrine of equity as a sword to preclude otherwise valid and important legal claims against it.

The remainder of JPMC's arguments are similarly without merit. As detailed in Section V below, JPMC's preemption argument based on SLUSA ignores the "entity exception" to that statute, and the legislative history, which is clear that bankruptcy trustees are exempted from the statute's reach. To the extent the Trustee is proceeding under Section 544(a) of the Bankruptcy

Code, SLUSA is inapplicable because he is standing in the shoes of a hypothetical judgment creditor. To the extent the Trustee is proceeding as a bailee, the Trustee seeks recovery for the entirety of the fund of customer property and the general estate.

Moreover, all of the Trustee's other common law claims are sufficiently pled, and should not be dismissed under Rule 12(b)(6). The Trustee's 148-page Amended Complaint contains more than sufficient facts, alleging aiding and abetting breach of fiduciary, fraud, and conversion; knowing participation; conversion; unjust enrichment; and fraud on the regulator.

In an effort to avoid the clear import of the Trustee's allegations, JPMC argues that banks would never knowingly engage in frauds. Not only is that statement belied by the *Enron* case and numerous other frauds in which JPMC has been involved, but the Amended Complaint alleges that JPMC specifically engaged in a cost/benefit analysis that took the likelihood of fraud into account. (Am. Compl. ¶ 7.) That JPMC bet wrong does not mean its conduct is not actionable.

JPMC also attempts to circumscribe the meaning of "actual knowledge" to escape liability for its misconduct, arguing that "actual knowledge" of a fraud in a complaint means something more than actual knowledge of facts that conclusively demonstrate a fraud. To the contrary, the Trustee need only plead facts from which an inference of actual knowledge is plausible. The Amended Complaint does just that, as it details JPMC's knowledge and notice of all aspects of the fraud that crossed divisions and levels of JPMC, implicated billions of dollars and hundreds of millions of JPMC's own money, and involved several prominent JPMC customers. These allegations rise far above mere "speculation." The Amended Complaint indeed makes specific allegations that JPMC was at the very center of Madoff's fraud and was complicit in it.

JPMC also argues that BLMIS's 703 Account was not a fiduciary account but rather an ordinary checking account, and that JPMC therefore had no fiduciary relationship with BLMIS customers. At a minimum, this is a factual issue not appropriate for resolution on a motion to dismiss. Regardless, JPMC knew of BLMIS's fiduciary relationship to its customers and participated in a breach of trust when it knowingly permitted billions of dollars to flow from customer to customer, or from Madoff to Madoff family members, as opposed to the purchase or selling of securities for the customer accounts.

Finally, JPMC's request for dismissal of the bankruptcy claims, relating to the loans JPMC extended to BLMIS in 2005 and 2006, should be rejected. As the Trustee has alleged, at the time it extended these loans, JPMC knew that Madoff was engaged in fraud and that BLMIS's customers had an interest in the 703 Account. (*See* Am. Compl. ¶ 291.) Neither federal nor state law permits a transferee to retain fraudulent transfers when, as here, the underlying obligation was made and the transfer was received in bad faith.

Based on the above, including the errors in the *HSBC* decision, this Court should find that the Trustee has standing to bring his suit and SLUSA does not preclude it. The Trustee has made detailed allegations of JPMC's misconduct and complicity in Madoff's fraud. The Amended Complaint should stand and the case should be permitted to go forward.

ARGUMENT

THE AMENDED COMPLAINT SHOULD STAND

I. THE BANKRUPTCY CODE ALLOWS THE TRUSTEE TO STAND IN THE SHOES OF THE DEBTOR TO BRING A CONTRIBUTION CLAIM, WHICH THE TRUSTEE HAS SUFFICIENTLY ALLEGED

No entity or individual, other than Madoff and his cohorts at BLMIS, was more crucial to Madoff's historic financial fraud than JPMC. As alleged, as Madoff's primary banker for more than 20 years, JPMC bounced billions of dollars back and forth between Madoff and his customers in patterns that could be explained only by fraud. The staggering daily activity in BLMIS's main account at JPMC (the "703 Account") was not only inconsistent with the purchase or sale of securities, it was explicable only as criminal activity. But JPMC did not merely continue to serve as Madoff's banker. It extended hundreds of millions of dollars of credit to his scheme, and structured and sold to investors financial products based on BLMIS, even as it internally acknowledged the probability that the entire operation was a fraud.

For JPMC, whether it was participating in a fraud mattered only to the extent the fraud would affect its bottom line. Thus, when performing due diligence on Madoff and BLMIS as it began to sell structured products related to BLMIS feeder funds in 2006, JPMC conducted a cost-benefit analysis: "'Based on overall estimated size of BLM strategy, . . . it would take [a] . . . fraud in the order of $3bn or more . . . for JPMC to be affected.'" (Am. Compl. ¶ 7.) In weighing the odds, JPMC took comfort in the fiduciary relationship between Madoff and/or BLMIS and the BLMIS customers, observing that, as with all the other money in the 703 Account, any investment in BLMIS would be "'treated as *customer money*'" and "'covered by SIPC.'" (*Id.*) (emphasis added.)

In October 2008, with the markets down and the risk of fraud affecting JPMC's bottom line all the greater, JPMC decided to withdraw its investments from BLMIS and admitted to British Authorities that "'[t]he investment performance achieved by [BLMIS's] funds . . . is so consistently and significantly ahead of its peers year-on-year, even in the prevailing market conditions, as to appear too good to be true—meaning that it probably is. . . .'" (*Id.* ¶ 11.) Notably, although JPMC eventually decided BLMIS was no longer worth the risk of exposing its own assets—even with SIPC "cover[age]"—it never stopped assisting Madoff in continuing the fraud against all of his other investors. The risk of Madoff's fraud *to other investors* never entered JPMC's calculations. By virtue of its conduct, JPMC is a joint tortfeasor.

A SIPA trustee, like an ordinary bankruptcy trustee, is permitted to step into the shoes of the debtor for the purpose of bringing the debtor's state law claims, including state law contribution claims against the debtor's joint tortfeasors. Both the Trustee's right to bring a contribution claim and the underlying tort claim itself emanate from New York state law, law that JPMC ignores when it argues the Trustee has no authority under SIPA to seek contribution.

A. SIPA and the Bankruptcy Code Authorize the Trustee to Bring a State Law Contribution Claim

The Bankruptcy Code, expressly incorporated by SIPA, grants the Trustee standing to bring state law claims, including contribution claims. JPMC's arguments to the contrary, which are based on the *HSBC* decision, are mistaken. *See HSBC*, 2011 WL 3200298, at *10; (Def. Br. 63–64.)

Section 78fff(b) of SIPA expressly incorporates portions of title 11 of the Bankruptcy Code, and § 541(a)(1) of the Bankruptcy Code makes clear that the "estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case." 15 U.S.C. § 78fff(b); 11 U.S.C. § 541(a)(1). Included in this property are all "choses in action" and claims the debtor has against others as of the commencement of the case. H. R. Rep. No. 95-595 at 158, 332 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6136, 6323; S. Rep. No. 95-989 at 79 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5868; *Air Line Pilots Ass'n, Int'l v. Am. Nat'l Bank & Trust Co. of Chicago* (*In re Ionosphere Clubs, Inc.*), 156 B.R. 414, 436–37 (S.D.N.Y. 1993), *aff'd*, 17 F.3d 600 (2d Cir. 1994) ("A debtor's interests in property, including causes of action, are defined by state law, and become assets of the estate once the bankruptcy petition is filed.").

BLMIS and JPMC are joint tortfeasors in that they each committed torts that resulted in the same harm to BLMIS customers. *See* N.Y. C.P.L.R. § 1401 (McKinney 1997). As a joint tortfeasor, BLMIS is entitled to contribution from JPMC for any liability BLMIS would have for those injuries. *Id.* These torts were committed prior to the commencement of the SIPA Proceeding. A debtor may have a contribution claim under N.Y. C.P.L.R. § 1401 for torts committed prior to the commencement of the proceeding. *See In re JMK Constr. Grp., Ltd.*, 441 B.R. 222, 231–33 (Bankr. S.D.N.Y. 2010).

The Trustee acquired BLMIS's contribution cause of action as property of the estate under § 541(a)(1) upon the commencement of the SIPA Proceeding. This contribution claim is the same as any other cause of action a bankruptcy trustee would acquire from the debtor as of the commencement of a bankruptcy proceeding. Accordingly, the Trustee is the appropriate party to bring this contribution claim against JPMC.

B. The Trustee's Underlying Tort Claim Emanates from New York Law, Not from a Breach of a Federal Statute

Citing to the *HSBC* decision, JPMC argues that the Trustee's contribution claim fails because SIPA does not give the Trustee the right to bring that claim. (Def. Br. 64–65.) That argument, however, only applies where the tort claim underlying the contribution arises from the breach of a federal statute. That is not the case here, where the underlying tort arises under New York state law.

The Trustee's right to contribution is based on breaches or violations of obligations imposed by state tort law, such as the obligation not to commit fraud or breach fiduciary duties. *See LNC Invs., Inc. v. First Fid. Bank, N.A.*, 935 F. Supp. 1333, 1348–49 (S.D.N.Y. 1996); *see also Nw. Airlines, Inc. v. Transp. Workers Union of Am., AFL-CIO*, 451 U.S. 77, 97 n.38 (1981)

("[F]ederal courts . . . have recognized a right to contribution under state law in cases in which state law supplied the appropriate rule of decision.").

The *LNC Investments* court explained the distinction between a contribution claim based on an underlying breach of a federal statute and a contribution claim based on an underlying violation of state tort law. 935 F. Supp. at 1340–49. There, investors in a trust sued several trustees after the owners of the trust went bankrupt, alleging that the trustees had violated the Trust Indenture Act's ("TIA") prudent person requirement and breached fiduciary duties under the TIA and New York common law. *Id.* at 1336. A trustee that had been sued by the investors ("trustee A") moved to implead a trustee that had not initially been sued ("trustee B") seeking contribution under the TIA and New York common law. *Id.*

The court denied the motion to implead based on the claim for contribution under the TIA, finding no evidence that Congress intended to create a right to contribution under the federal statute. *Id.* at 1340–46. But the court allowed trustee A to implead trustee B for contribution on the basis of the New York state tort law claims. *Id.* at 1346–49. The court explained that "[b]ecause plaintiff alleges that [trustee A] has committed the tort of a breach of fiduciary duty, and because that tort exists under New York law, [trustee A] may seek contribution from joint tort-feasors." *Id.* at 1348. Trustee B was a joint tortfeasor because if found liable, he had caused the "same injury" to the investors as trustee A. *Id.* A contribution claim existed under state law because the source of the right to contribution was "an obligation imposed by state law." *Id.* at 1349.

The cases relied on by JPMC and in *HSBC* for the proposition that the Trustee may not seek contribution under New York state law are inapposite because the plaintiffs in those cases attempted to allege a New York state law contribution claim based on a breach of a federal act (specifically, the Copyright Act). *See KBL Corp. v. Arnouts*, 646 F. Supp. 2d 335, 339–41 (S.D.N.Y. 2009) (attempting to bring state law contribution claim based on liability for copyright infringement under the Copyright Act); *Lehman Bros., Inc. v. Wu*, 294 F. Supp. 2d 504, 505 n.1 (S.D.N.Y. 2003) (same). In contrast, the Trustee is alleging a New York state law contribution claim based on torts committed by BLMIS and JPMC in violation of New York state law.

C. The Trustee Has Sufficiently Alleged a Contribution Claim

JPMC's contention that the Trustee has failed to allege the elements of a contribution claim is also incorrect. (*See* Def. Br. 65–67.) "[T]wo or more persons who are subject to liability for damages for the same . . . injury to property . . . may claim contribution among them whether or not an action has been brought or a judgment has been rendered against the person from whom contribution is sought." N.Y. C.P.L.R. § 1401. The Trustee has alleged that BLMIS and JPMC are joint tortfeasors subject to liability for the same injury: the losses incurred by BLMIS customers. (Am. Compl. ¶¶ 490–583.) Contrary to JPMC's claim, and as explained further below, the Trustee has adequately alleged tort claims against JPMC. On a motion to dismiss, it is enough that the Trustee has adequately alleged that JPMC has tort liability; the Trustee need not prove JPMC is actually liable in tort until trial. *See LNC Invs.*, 935 F. Supp. at 1349.

JPMC, relying on *dicta* in the *HSBC* decision, also contends that the Trustee's obligation to pay customer claims under SIPA does not meet the New York contribution statute's requirement that the party seeking contribution be subject to liability for damages. (Def. Br. 64–65) (citing *HSBC*, 2011 WL 3200298, at *10). Courts in New York have interpreted § 1401's liability requirement to mean that the Trustee must be "compelled in some way . . . to make the payment against which contribution is sought." *N.Y. State Elec. & Gas Corp. v. FirstEnergy Corp.*, No. 3:03-CV-0438 (DEP), 2007 WL 1434901, at *7 (N.D.N.Y. May 11, 2007); *see also*

Hill v. Day (*In re Today's Destiny, Inc.*), 388 B.R. 737, 750–51 (Bankr. S.D. Tex. 2008). Although the compulsion to pay may commonly take the form of a money judgment, the statute does not, as the *HSBC* decision and JPMC summarily imply, so require—other compulsions to pay will suffice. *See FirstEnergy Corp.*, 2007 WL 1434901, at *7 (allowing a contribution claim arising out of consensual administrative orders because the orders imposed "tort-like liability"). The compulsion to pay in this case is the Trustee's obligation to pay customer claims under SIPA.

Today's Destiny upheld a contribution claim in similar circumstances. 388 B.R. at 751. In that case, a debtor had committed fraud in the sale and leasing of equipment and the purchasers of the equipment filed nearly 300 proofs of claim with the bankruptcy estate. *Id.* at 750–51. The bankruptcy trustee brought contribution claims against certain lenders based on allegations that the lenders had aided and abetted the debtor's fraud. *Id*. at 750. The court found that the trustee had stated a valid claim for contribution under Texas state law, *id.* at 751, and explained that "[a]fter the objection deadline passes and all objections have been resolved, [the debtor's] liability for [the] claims will be fixed pursuant to Court orders." *Id.* at 755. Accordingly, the estate had a contribution right against the lenders to the extent the court's orders allowed the customers' proofs of claim. *Id.* The same outcome is appropriate here.

Under JPMC's view of contribution, SIPA and the Bankruptcy Code would have the contrary effect of shielding third-party tortfeasors who, along with the broker-dealer, harmed the broker-dealer's customers, from the contribution claims that the joint tortfeasors would otherwise face. As with any bankruptcy proceeding, the victims are not permitted to bring tort claims against the BLMIS estate by virtue of the automatic stay. *See SEC v. Bernard L. Madoff*, 08-CIV-10791 (LLS), Dkt. No. 4 (S.D.N.Y. Dec. 15, 2008); 11 U.S.C. § 362(a); 15 U.S.C.

§ 78eee(b)(2)(B)(i). Instead, in order to be compensated for their losses, the customers must file claims in the Bankruptcy Court pursuant to the customer claims procedure. In the absence of a bankruptcy or SIPA proceeding, the customers would be able to bring tort claims against BLMIS, and JPMC, as joint tortfeasor, would be liable for contribution for its share of the customers' injuries. A finding that SIPA shields a broker-dealer's joint tortfeasors from liability they would otherwise face would be inconsistent with the purpose of SIPA.

Similarly, JPMC's argument that "the Trustee has failed to plead that BLMIS has paid—or ever will pay—more than its 'equitable share' of any judgment, as required to state a contribution claim" has no merit. (Def. Br. 66.) The Trustee has impleaded JPMC into the SIPA proceeding, which is where BLMIS's liability ultimately will be determined. (Am. Compl. ¶ 21.) Where a plaintiff seeks contribution by way of impleader, New York does not require the plaintiff to establish a compulsion to make payment beyond that party's equitable share. *See, e.g.*, *Andrulonis v. United States*, 26 F.3d 1224, 1233 (2d Cir. 1994) ("In a federal case governed by New York law, Rule 14(a) nevertheless permits a defendant to implead a joint tortfeasor for contribution before the right to contribution accrues, because that third party 'may be' liable to the defendant for a share of the plaintiff's primary judgment."); *Klinger v. Dudley*, 41 N.Y.2d 362, 369 (1977) ("[A] main defendant may assert his claim for contribution prior to the payment of any amount to the plaintiff.").

The reason behind this rule is to promote judicial efficiency. The amount that BLMIS will be compelled to pay and what represents its "equitable share" have not yet been finally determined, as the claims allowance process is ongoing. (*See* Am. Compl. ¶ 21.) To the extent it becomes necessary for the Trustee to move to implead JPMC into the individual contested claims proceedings, the Trustee will do so under Federal Rule of Bankruptcy Procedure 9014. *See* Fed.

R. Bankr. P. 9014(c) ("The court may at any stage in a particular matter direct that [the impleader rule] shall apply."). JPMC's compulsion to pay will ultimately be determined upon final resolution of the SIPA proceeding. The Trustee is not required to allege the scope of liability before it is determined.

II. THE BANKRUPTCY CODE ALLOWS THE TRUSTEE TO STAND IN THE SHOES OF A JUDGMENT CREDITOR AND ASSERT COMMON LAW CLAIMS AGAINST JPMC

In addition to claims belonging to the debtor, the Trustee is also empowered to bring claims standing in the shoes of an innocent judgment creditor under § 544(a) of the Bankruptcy Code. *See St. Paul*, 884 F.2d at 700-01. Under that provision, the Trustee has standing to sue third parties under two different theories. First, the Trustee has standing to bring claims that, like the ones here, allege harm to all creditors, and his standing to bring those claims is exclusive in this Circuit: "If a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim." *Id.* at 701. Second, the Trustee has standing under § 544(a) and New York law to appropriate the debtor's causes of action against third parties to satisfy the Trustee's hypothetical unsatisfied judgment. And when the Trustee does so, he asserts those causes of action free of *in pari delicto.*

A. The Trustee Has Standing Under Section 544(a) of the Bankruptcy Code to Bring Common Law Claims Against JPMC as a Hypothetical Judgment Creditor

Under Bankruptcy Code § 544(a), the Trustee has standing to assert his common law causes of action, free of any personal defenses such as *in pari delicto*, as a "hypothetical judgment creditor." Section 544(a) provides in pertinent part that:

> The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may

> avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists; [or]
>
> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists . . . .

11 U.S.C. § 544(a). These rights and powers are commonly referred to as a trustee's "strong arm powers." *See Musso v. Ostashko*, 468 F.3d 99, 102 (2d Cir. 2006).

What is a "hypothetical judgment creditor?" Put simply, § 544(a) places a trustee in the shoes of a hypothetical creditor who obtained a judgment against the debtor, allowing the trustee to exercise all of "the rights and powers" of such a creditor resulting from the fact that the judgment remains unsatisfied. It does not matter whether such a creditor actually exists or what the judgment is for. In other words, if a creditor could have obtained a judgment against the debtor—even if none did—the trustee has all of the rights and powers of that creditor, including the ability to assert causes of action, as permitted under relevant state law. *See id.* at 105 ("Section 544(a)(1) thus puts the trustee in the position of an ideal lien creditor, armed with a judgment and with all the power that state law confers on such ideal creditors."); *see also Cent. Hanover Bank & Trust Co. v. Manhattan Co.*, 105 F.2d 130, 131 (2d Cir. 1939) (L. Hand, J.) ("The trustee is vested . . . with all the powers of a judgment creditor" under predecessor to § 544); *Pereira v. Checkmate Commc'ns Co.* (*In re Checkmate Stereo & Elecs., Ltd.*), 9 B.R. 585, 591 (Bankr. E.D.N.Y. 1981) ("[Section 544] gives the trustee in bankruptcy every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings.") (internal quotations and citations omitted).

As the Tenth Circuit has explained:

> To understand the full import of [section] 544, one must first understand the power of a bankruptcy trustee to stand in the shoes of a[n] hypothetical creditor of the debtor to effect a recovery from a third party. Simply stated, from the reservoir of equitable powers granted to the trustee to maximize the bankruptcy estate, Congress has fashioned a legal fiction. *Not only is a trustee empowered to stand in the shoes of a debtor to set aside transfers to third parties, but the fiction permits the trustee also to assume the guise of a creditor with a judgment against the debtor. Under that guise, the trustee may invoke whatever remedies provided by state law to judgment lien creditors to satisfy judgments against the debtor.*

Zilkha Energy Co. v. Leighton, 920 F.2d 1520, 1523 (10th Cir. 1990) (emphasis added).

Under this section of the Bankruptcy Code, the Trustee can assert his common law claims against JPMC standing in the shoes of a judgment creditor.

B. As a Hypothetical Judgment Creditor, the Trustee Possesses All of the Rights and Powers of an Unsatisfied Judgment Creditor of BLMIS Under New York Law

Unlike claims brought under 11 U.S.C. § 541(a)(1), which are brought by a trustee standing in the shoes of the debtor, a trustee brings claims under § 544(a) standing in the shoes of an innocent creditor. *See, e.g., Fundex Capital Corp. v. Balaber-Strauss* (*In re Tampa Chain Co.*), 53 B.R. 772, 777–78 (Bankr. S.D.N.Y. 1985); *Official Comm. of Unsecured Creditors of Am.'s Hobby Ctr., Inc. v. Hudson United Bank* (*In re Am.'s Hobby Ctr., Inc.*), 223 B.R. 275, 287 (Bankr. S.D.N.Y. 1998) (quoting N.Y. C.P.L.R. 5202(a)).

Section 544(a) expressly grants a trustee whatever "rights and powers" a creditor with an unsatisfied judgment would have under state law. Those rights and powers include the ability to assert two types of claims.

The first type of claim is a cause of action that all general creditors of the judgment debtor possess, namely, a cause of action asserting generalized harm to all creditors. *See Hill v. Gibson Dunn & Crutcher, LLP* (*In re MS55, Inc.*), No. 06-cv-01233-EWN, 2007 WL 2669150, at *12 (D. Colo. Sept. 6, 2007) (when trustee asserts claims as hypothetical judgment creditor, he "is necessarily asserting claims general to any and all judgment . . . creditors"); *Fisher v. Am. Nat'l Bank & Trust Co. of Chicago* (*In re Elite Mktg. Enters., Inc.*), No. 99 B 29921, 2001 WL 1669229, at *4 (Bankr. N.D. Ill. Dec. 13, 2001) (trustee has standing "to prosecute general claims of unsecured creditors under § 544 of the Bankruptcy Code . . . [t]he trustee can proceed if he alleges . . . a 'general' injury to the unsecured creditors").

The second type of claim that a judgment creditor can bring is a "chose in action"—a cause of action, originally belonging to the debtor, that the judgment creditor can enforce to help satisfy the creditor's unsatisfied judgment against the debtor. *See Koch Ref. v. Farmers Union Cent. Exch.*, 831 F.2d 1339, 1342–49 (7th Cir. 1987) ("Pursuant to 11 U.S.C. § 544 the trustee, in his capacity as creditor, may bring suit to reach property or choses in action belonging to the estate that will then be distributed to all creditors.").

The powers of the hypothetical judgment creditor are determined by state law, in this case New York law. *Robinson v. Howard Bank* (*In re Kors, Inc.*), 819 F.2d 19, 22–23 (2d Cir. 1987) ("Once the trustee has assumed the status of a hypothetical lien creditor under § 544(a)(1), state law is used to determine what the lien creditor's priorities and rights are.") (internal citations omitted).

C. Standing in the Shoes of a Hypothetical Judgment Creditor, the Trustee Can Bring Common Law Claims Directly Against JPMC

Under New York law, once a company becomes insolvent, its officers and directors owe fiduciary duties directly to its creditors under the "trust fund doctrine." *RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184, 202 (S.D.N.Y. 2009). Under this doctrine, "'officers and directors of an insolvent corporation are said to hold the remaining corporate assets in trust for the benefit of its general creditors.'" *Id.* (quoting *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 94 N.Y.2d 541, 549 (2000)). Therefore, "'directors of an insolvent corporation owe a fiduciary duty to preserve the assets of the corporation for the benefit of creditors.'" *Bildirici*, 649 F. Supp. 2d at 202 (quoting *Hughes v. BCI Int'l Holdings, Inc.*, 452 F. Supp. 2d 290, 308 (S.D.N.Y. 2006)); *see also Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *N.Y. Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953). The trust fund doctrine serves "the New York policy to preserve the assets of insolvent corporations for the creditors." *Clarkson*, 660 F.2d at 512 (citing *Ward v. City Trust Co. of N.Y.*, 84 N.E. 585, 589 (N.Y. 1908)).

These principles apply with equal force to a limited liability company. *See, e.g.*, *Kittay v. Atl. Bank of N.Y.* (*In re Global Serv. Grp., LLC*), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (applying trust fund doctrine to LLC); *Bildirici*, 649 F. Supp. 2d at 213 (same as to PLC); *see generally Tzolis v. Wolff*, 10 N.Y.3d 100, 104–09 (N.Y. 2008) (applying corporate derivative liability concepts to LLCs); *Gitlin v. Chirinkin*, No. 012131/07, 2011 WL 3276708, at *6 (N.Y. Sup. Ct. Nassau County June 29, 2011) (describing fiduciary duties in LLC context).

Because Madoff perpetrated a Ponzi scheme, BLMIS has been insolvent since the Ponzi scheme began. *See Cunningham v. Brown*, 265 U.S. 1, 8 (1924) (given his fraudulent scheme, Charles Ponzi "was always insolvent, and became daily more so, the more his business succeeded"); *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006) (same); *Daly v. Deptula* (*In re Carrozzella & Richardson*), 286 B.R. 480, 486 n.17 (D. Conn. 2002) (same).

Because BLMIS was insolvent over the life of the scheme, Madoff, in his role as an officer and member of BLMIS, owed duties to BLMIS's creditors to preserve its assets. *See Bildirici*, 649 F. Supp. 2d at 202; *Hughes*, 452 F. Supp. 2d at 308 (citing *Clarkson*, 660 F.2d at

512, and *Weiss*, 110 N.E.2d at 400).[2] Accordingly, whatever causes of action arise from a violation of those duties accrue to creditors damaged by Madoff's scheme and are thus, by virtue of § 544(a), causes of action that the Trustee possesses. And clothed in the guise of a creditor, the Trustee's causes of action are not limited to those against the debtor (which in liquidation, would take the form of a proof of claim), but may be brought against third parties that also damaged creditors. *See, e.g.*, *In re Elite Mktg. Enters.*, 2001 WL 1669229, at *4 (trustee had standing to assert "general" injury to unsecured creditors through unjust enrichment claim against third party bank that had assisted debtor in falsifying loan documents and thereby harmed those that may have lent additional money to the debtor under false pretenses).

The "trust fund doctrine" confers standing on a creditor—whether by virtue of a judgment or otherwise—to assert causes of action against a company's officers and directors, as well as third party aiders and abettors, which derive from the officer or director's diversion of corporate assets for his own benefit to the detriment of the enterprise and its creditors. *See generally In re Mortg. Am. Corp.*, 714 F.2d 1266, 1276 (5th Cir. 1983). Here, the gravamen of the Trustee's common law claims is that JPMC caused billions of dollars in damages to BLMIS's creditors by aiding Madoff in perpetuating his Ponzi scheme—by, among other things, aiding and abetting Madoff's fraud, breach of fiduciary duty and conversion, unlawfully converting creditor funds, knowingly participating in a breach of trust, and being unjustly enriched at the expense of creditors. The Trustee has statutory standing under § 544(a) to assert these claims as a judgment creditor.

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[2] While a trustee stands in the shoes of a hypothetical judgment creditor as of the commencement of the liquidation under § 544(a), liability for improperly wasting company assets extends to acts taken before the judgment. *See, e.g., Aktieselskabet Christianssand v. Fed. S.S. Corp.*, 201 N.Y.S. 504, 506 (Sup. Ct. N.Y. County 1923) ("a subsequent creditor can rely upon the assumption that the capital of a corporation has not been depleted by illegal conduct of the directors.").

In *Gibson Dunn*, the debtor filed a chapter 11 petition after financial transactions involving two of its biggest investors failed. 2007 WL 2669150, at *2. The case was ultimately converted to a chapter 7 proceeding, at which point the trustee asserted various common law claims against attorneys who had acted as the debtor's legal counsel during the financial transactions. *Id.* at *2–3. These included breach of fiduciary duty, conspiracy, legal malpractice, negligence, aiding and abetting breach of fiduciary duty, and securities fraud. *Id.* at *3, *5. The district court concluded that creditors would have had the right to assert those causes of action under applicable state law, and further held that acting as a hypothetical judgment creditor, the trustee similarly could assert such causes of action under § 544(a). *See id.* at *10–15; *see also Lumbard v. Maglia, Inc.*, 621 F. Supp. 1529, 1542 (S.D.N.Y. 1985) (under § 544, trustee could bring RICO claims against those who aided and abetted the diversion of the debtor's assets: "Section 544, the 'strong arm' provision, provides ample statutory authority for a Chapter 7 trustee's assertion of creditors' claims against third parties").

Atypical of most chapter 7 and 11 cases, BLMIS was a massive Ponzi scheme, insolvent from the scheme's inception, in which the Trustee has alleged that JPMC aided and prolonged the scheme. It is precisely for these reasons that the claims for breaches of fiduciary duty and other actionable harms caused by third parties, *i.e.*, JPMC, exist. BLMIS, as found by the Second Circuit in its "net equity decision," stands as an "extraordinary" case of fraud both for its breadth and duration. *In re Bernard L. Madoff Inv. Sec. LLC*, No. 10-2378-bk, 2011 WL 3568936, at *8 (2d Cir. Aug. 16, 2011). The Trustee's invocation of § 544(a) to bring common law claims against JPMC in his capacity as a judgment creditor is part and parcel of the tool kit granted by Congress to bankruptcy trustees to maximize the estate's recovery for the benefit of all creditors. *See Faircloth v. Paul* (*In re Int'l Gold Bullion Exch.*, *Inc.*), 60 B.R. 261, 264 (Bankr. S.D. Fla. 1986).

D. The Trustee Can Also Bring Claims of BLMIS Against JPMC, as Those Claims are Assignable Under New York Law to an Unsatisfied Judgment Creditor

New York law provides that a creditor whose judgment is unsatisfied can enforce it against any of the debtor's property, including causes of action (also termed "choses in action"). *See generally* N.Y. C.P.L.R. § 5201(a) ("A money judgment may be enforced against . . . a cause of action which could be assigned or transferred accruing within or without the state."). The Trustee, standing in the shoes of a hypothetical judgment creditor under § 544(a), has had his judgment returned unsatisfied. Accordingly, he can look to satisfy that judgment by enforcing choses in action that belong to the debtor. *See Koch Ref.*, 831 F.2d at 1342 ("Pursuant to 11 U.S.C. § 544 the trustee, in his capacity as creditor, may bring suit to reach property or choses in action belonging to the estate that will then be distributed to all creditors"); *Port Chester Elec. Constr. Corp. v. Atlas*, 40 N.Y.2d 652, 657 (1976) (judgment creditor may enforce causes of action that the judgment debtor possesses).

Under New York law, causes of action are freely assignable with certain limited exceptions not applicable here. *See* N.Y.G.O.L. § 13-101; *Semi-Tech Litig., L.L.C. v. Ting*, 787 N.Y.S.2d 234, 236 (1st Dep't 2004) (assignment of claims for fraud and aiding and abetting fraud); *Client's Sec. Fund of the State of N.Y. v. Goldome*, 560 N.Y.S.2d 84, 87 (N.Y. Sup. Ct. 1990) (conversion); *Skilled Investors, Inc. v. Bank Julius Baer & Co.*, 878 N.Y.S.2d 53, 54 (1st Dep't 2009) (unjust enrichment); *Certain Underwriters at Lloyd's, London v. Foster Wheeler Corp.*, 822 N.Y.S.2d 30, 40–41 (1st Dep't 2006) (contribution); *see also O'Halloran v. PricewaterhouseCoopers LLP*, 969 So. 2d 1039, 1048–49 (Fla. App. 2007) (aiding and abetting breach of fiduciary duty claim).

As BLMIS possesses claims against JPMC for aiding and abetting Madoff's fraud, conversion, and breach of fiduciary duty, as well as for conversion, unjust enrichment, and knowing participation in Madoff's breach of trust, the Trustee can look to satisfy his unsatisfied judgment through the enforcement of those claims under New York law.

As discussed below, even if those claims would be barred by *in pari delicto* if brought under § 541—because under that section the Trustee stands in the shoes of the debtor, subject to the defenses to which the debtor is subject—*in pari delicto* would not bar those actions when the Trustee stands in the shoes of an innocent creditor. *See, e.g.*, *Geltzer v. Mooney* (*In re MacMenamin's Grill Ltd.*), 450 B.R. 414, 431 (Bankr. S.D.N.Y. 2011) (the *Wagoner* Rule and *in pari delicto* do not apply to a trustee "who has independent standing under section 544"); *Cent. Hanover*, 105 F.2d at 131–32 (L. Hand, J.) ("there are occasions when [a trustee] may represent creditors when the defendant would have had no standing").

Accordingly, whether the common law causes of action that the Trustee asserts are viewed as direct actions brought in the shoes of a judgment creditor, or are viewed as claims that originally belonged to the debtor that are enforced by a judgment creditor under New York law, the Trustee has standing to assert them under § 544(a).[3]

E. The Trustee's Standing to Bring These Claims Is Exclusive

The claims against JPMC alleged by the Trustee standing in the shoes of a judgment creditor assert a generalized harm common to all creditors as a result of JPMC's alleged actions in facilitating the Ponzi scheme and deepening BLMIS's insolvency. *See, e.g., Gibson Dunn*, 2007 WL 2669150, at *12. Because the claims that the Trustee asserts involve a generalized

[3] Accordingly, "[w]hether a creditor's cause of action is direct or derivative has nothing to do with the issue of whether a judgment-lien creditor has the right to bring the action." *Hill v. Gibson Dunn & Crutcher, LLP* (*In re MS55, Inc.*), No. 06-cv-01233-EWN, 2008 WL 2358699, at *2 (D.Colo. June 6, 2008).

injury to all creditors, the Trustee is the only one who can assert such claims in a liquidation proceeding. "If a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim." *St. Paul*, 884 F.2d at 701; *In re Saint Vincents Catholic Med.*, 449 B.R. at 218 (agreeing that "the trustee had exclusive standing to bring causes of action that generally affect all creditors"). Thus, the Trustee's standing to bring his common law claims against JPMC under § 544(a) is wholly consonant with established Second Circuit precedent.

F. Section 544(a) Is Not Limited to Avoidance Actions

JPMC argues in a footnote that it is "settled law" that § 544(a) applies only to avoidance actions, and fails to address the matter further. (Def. Br. 11 n.4.) But numerous cases have held that § 544(a) applies to more than avoidance actions. *See Gibson Dunn*, 2007 WL 2669150, at *10–12 (claims for civil conspiracy and aiding and abetting breach of fiduciary duty); *Sender v. Porter* (*In re Porter McLeod, Inc.*), 231 B.R. 786, 792–93 (D. Colo. 1999) (professional malpractice and aiding and abetting breach of fiduciary duty claims against certain third parties); *Sender v. Mann*, 423 F. Supp. 2d 1155, 1173–74 (D. Colo. 2006) (aiding and abetting breach of fiduciary duty, aiding and abetting fraud, legal malpractice, and civil conspiracy claims against certain third parties); *Collins v. Kohlberg & Co.* (*In re Sw. Supermarkets, LLC*), 325 B.R. 417, 425–26 (Bankr. D. Ariz. 2005) ("some kinds of affirmative damages actions can be asserted under § 544(a)(2), not just avoidance of secret liens"); *Koch Ref.*, 831 F.2d at 1342–43 (state law alter ego action against corporation's fiduciaries); *Keene Corp. v. Coleman* (*In re Keene Corp.*), 164 B.R. 844, 851 (Bankr. S.D.N.Y. 1994) (trustee's "strong arm" powers permit trustee to assert state law claims belonging to creditors); *Lumbard*, 621 F. Supp. at 1542 (RICO claims against third parties).

It is these cases that hew to the plain language of the statute. Section 544(a) provides that a trustee has "the rights and powers of" a hypothetical judgment creditor *or* the ability to "avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by" a hypothetical judgment creditor. 11 U.S.C. § 544(a) ("The trustee shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . .").

The use of the conjunction "or" in the statute indicates that the "rights and powers" clause is separate and distinct from the avoidance clause. *See Gibson Dunn*, 2007 WL 2669150, at *11 (the "language of section 544(a) supports a finding that trustees are endowed with more than solely avoidance powers"); *In re Sw. Supermarkets, LLC*, 325 B.R. at 426.

In addition to the plain meaning of § 544(a), a review of pre-Code bankruptcy law and legislative history supports this interpretation. Under the predecessor statute to § 544, § 70(c) of the Bankruptcy Act, 11 U.S.C. § 110(c) (repealed), the "rights and powers" of the trustee as a judgment creditor did not include avoidance provisions at all. *See In re Mill Concepts Corp.*, 123 B.R. 938, 940 n.3 (Bankr. D. Mass. 1991) (quoting § 70(c)).

When Congress enacted § 544(a) in 1978, it stated that "[t]he avoiding powers under section 544(a)(1), and (2), and (3) are new." H.R. Rep. No. 95-595, (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6456. Given that the avoidance powers of § 544(a) were new in 1978, and that the "rights and powers" language of the predecessor statute was retained, it is nonsensical to suggest that § 544(a) is limited to avoidance actions.

Were that not enough, Congress expressly stated that it intended § 544(a) to reach causes of action other than avoidance actions. In the legislative history of the enactment of the Bankruptcy Code in 1978, Congress stated that if a debtor partnership's assets are insufficient to pay all claims against the estate, the Uniform Partnership Act gives the debtor a right to compel contribution against the partnership's partners, and noted that "the lien under 11 U.S.C. § 544(a) is only on the chose in action, not on the property directly." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6160. Thus, Congress expressly contemplated that a trustee, acting as a judgment creditor, would have a lien on the debtor's cause of action for contribution.

In short, under the statute's plain language, the evolution of the statutory language, and the expressed intent of Congress, § 544(a) is not limited to avoidance actions. To the contrary, the Trustee may, in addition to avoiding transfers of the debtor's property, assume *all* the "rights and powers" of a hypothetical judgment creditor available under state law. *See Leighton*, 920 F.2d at 1523.

JPMC cites to a single bankruptcy court case, *Goldin v. Primavera Familienstiftung* (*In re Granite Partners, L.P.*), 194 B.R. 318, 324 (Bankr. S.D.N.Y. 1996), as well as to 5 Collier on Bankruptcy ¶ 544.01 (16th ed. 2011), for the proposition that § 544(a) is limited to avoidance actions. (Def. Br. 11 n.5.) But *Granite Partners* relies exclusively on Collier, and Collier's conclusion (along with the holdings of courts that have followed that conclusion) is contrary to the plain language of the statute and its legislative history, and ignores cases that have reached the opposite conclusion. Further, of the two cases Collier cites for this proposition, one refers back to Collier, and the other grounds its conclusion in the Supreme Court's decision in *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 434 (1972). As set forth immediately below, *Caplin* has no relevance to the § 544(a) analysis, because the predecessor to § 544(a), § 70(c) of the Bankruptcy Act, was not in effect when the *Caplin* liquidation commenced, and the Second Circuit's decision in *St. Paul* rejected the notion that *Caplin* limits causes of action asserted under § 544 to only avoidance actions. *St. Paul*, 884 F.2d at 702 n.3.

G. *Caplin* and Its Progeny Do Not Bar Actions by the Trustee as a Hypothetical Judgment Creditor

Those cases that have held that § 544(a) does not reach beyond avoidance actions generally rely on the proposition generally attributed to *Caplin*, 406 U.S. at 434, that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself. But *Caplin* was grounded in the precursor to § 541, namely actions brought in which the trustee stands in the shoes of the corporation—asserting claims that the corporation owned at the commencement of the bankruptcy proceeding.

Under § 544, however, the Trustee has express statutory authority to stand in the shoes of a hypothetical judgment creditor, not the debtor. And in 1965, when the liquidation in *Caplin* began, the hypothetical judgment creditor powers did not exist. *See* Vern Countryman, *The Use of State Law in Bankruptcy Cases* (*Part II*), 47 N.Y.U.L. Rev. 631, 650–51 (1972) (prior § 70(c) was deleted in 1950 and not reinserted until 1966); Frank R. Kennedy, *The Bankruptcy Amendments of 1966*, 1 Ga. Law Rev. 149, 167 (1967) (same); *see also Steven E. Boyce, Koch Refining* and *In re Ozark: The Chapter 7 Trustee's Standing to Assert an Alter Ego Cause of Action*, 64 Am. Bankr. L. J. 315, 325, n.66 (1990) (same). Accordingly, the *Caplin* Court could not have considered the implications of hypothetical judgment creditor status on a trustee's ability to bring third-party claims.

In *St. Paul*, the Second Circuit expressly rejected the notion that *Caplin* served to bar all third-party actions by a trustee on behalf of creditors. 884 F.2d at 700–01. *St. Paul* held that a bankruptcy trustee had the exclusive authority to bring a state alter ego tort claim on behalf of creditors against a third party when generalized harm to creditors was asserted. *Id.* at 705. The Second Circuit noted that in a prior opinion, it had written in *dicta* that "'[t]he Trustee in bankruptcy has standing to represent only the interests of the debtor corporation.'" *Id.* at 702 n.3. The correct proposition, the Second Circuit held, is "that causes of action that could be asserted by the debtor are property of the estate and should be asserted by the trustee, *as should causes of action such as those that fall under 11 U.S.C. §§ 544, 547, 548*." *Id.* (emphasis added). Thus, under *St. Paul*, an action under § 544 against a third party may proceed when the action asserts a generalized harm to creditors.

The *Gibson Dunn* court also found *Caplin*'s concerns inapplicable in light of the "Bankruptcy Code's expressed intent to promote equality of distribution among similarly situated creditors." 2007 WL 2669150, at *13 (citing H.R. Rep. No. 95-595, 340, 95th Cong., 1st Sess. (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6297). As the Second Circuit reasoned in *St. Paul*, permitting a trustee to assert generalized creditor claims against third parties "would have the effect of bringing the property of the third party into the debtor's estate, and thus would benefit all creditors." 884 F.2d at 701. So too here.

Certain cases wrongly reason that § 544(a) reaches only avoidance actions because Congress failed to enact proposed § 544(c), a provision that was designed to reverse *Caplin*'s holding, in the 1978 amendments to the Bankruptcy Code. *See, e.g, Mixon v. Anderson* (*In re Ozark Restaurant Equip.*), 816 F.2d 1222, 1227–28 (8th Cir. 1987). But the Second Circuit has rejected any inference from Congress's failure to pass this subsection, holding that "[t]here is no evidence to suggest the grounds on which proposed § 544(c) was actually rejected." *CBI*, 529 F.3d at 458. Absent such evidence, no inferences can be drawn from Congress's refusal to enact § 544(c).

In any event, *Caplin* did not bar creditor claims like those asserted here, which allege generalized harm. Thus, Congress's failure to overrule *Caplin* statutorily has no bearing on those claims. *See Koch Ref.*, 831 F.2d at 1347 n.11 ("the deletion of [§ 544(c)] means only that *Caplin* is not overruled and that there is no express statutory provision allowing a trustee to bring an action which *certain* creditors, like debenture holders, have. The omission does not affect a trustee's right to bring a general action on behalf of all creditors rather than a personal one on behalf of only some.") (emphasis in original); *see also Gibson Dunn*, 2007 WL 2669150, at *11–13.

While JPMC may argue that Congress did not intend to give authority to trustees beyond avoidance actions, JPMC has to read the "rights and powers" language out of § 544(a) in doing so.

III. THE TRUSTEE HAS STANDING AS BAILEE, SUBROGEE, AND ASSIGNEE TO BRING COMMON LAW CLAIMS

A. The Trustee Has Standing as the Bailee of Customer Property

1. The Second Circuit Held in *Redington* that a SIPA Trustee has Standing to Sue as a Bailee and that SIPC Has Standing to Sue as a Subrogee

The Second Circuit in *Redington* held that a SIPA trustee is a bailee of customer property. 592 F.2d at 625. A SIPA trustee is responsible for marshaling and returning customer property, and to the extent he is unable to do so, he may sue on behalf of the customers/bailors any wrongdoer they could sue themselves. 15 U.S.C. § 78fff-1(b); *Redington*, 592 F.2d at 625. To establish standing as a bailee, a SIPA trustee must expressly allege that SIPC has been unable to fully reimburse all customers for all of their losses. *Picard v. Taylor* (*In re Park S. Sec., LLC*), 326 B.R. 505, 517 (S.D.N.Y. 2005). The Trustee has made these allegations in his Amended Complaint, and therefore has standing to bring customer claims against JPMC as a bailee. (Am. Compl. ¶ 20(a)–(f).)

In *Redington*, a SIPA trustee and SIPC filed an action for damages against the debtor's accounting firm based on the auditor's alleged misconduct in auditing the failed broker. 592 F. 2d at 619–20. The trustee and SIPC brought common law claims and claims for violations of § 17(a) of the Securities and Exchange Act of 1934 (the "Exchange Act") and the regulations promulgated thereunder. *Id.* at 620.

In reversing the district court's dismissal of the § 17(a) claims, the Second Circuit held that a SIPA trustee, as bailee, has standing to sue third-party wrongdoers to the extent the trustee is unable to satisfy customers' net equity claims. *Id.* at 625. The court also held that SIPC can sue as the equitable subrogee of customers to whom it made advances to cover their losses of customer property. *Id.* at 624. The Second Circuit further held that § 17(a) provides a private right of action to customers of a broker dealer, and that the SIPA trustee and SIPC could bring those claims—for harm to customer property—as bailee and subrogee, respectively. *Id.* at 623–25.

While the Supreme Court subsequently reversed the Second Circuit's determination that § 17(a) created a private right of action, *Redington*, 442 U.S. at 579, the Supreme Court left undisturbed the Second Circuit's holdings that a SIPA trustee has standing as bailee of the fund of customer property, and that SIPC has standing as subrogee, to pursue claims against third parties. *Id.* at 567 n.9.

2. *Redington* Remains the Law of This Circuit

a. *Redington's* Standing Determination Is Binding Precedent

It is well settled that a holding of the Second Circuit is binding unless it is overruled expressly or impliedly by an *en banc* decision of the Second Circuit or the Supreme Court. *See BankBoston, N.A. v. Sokolowski (In re Sokolowski)*, 205 F.3d 532, 534–35 (2d Cir. 2000). The Second Circuit's standing determinations in *Redington* remain the law of the Circuit, as neither an *en banc* panel of the Circuit, nor the Supreme Court, has questioned them, much less overruled them. Indeed, in the only Second Circuit case to touch on *Redington*'s standing determinations, the Circuit noted the binding nature of those determinations, quoting *Sokolowski. SIPC v. BDO Seidman, LLP*, 222 F.3d 63, 69 (2d Cir. 2000) (quoting 205 F.3d at 534–35).

In *BDO Seidman*, a SIPA trustee and SIPC brought an action seeking damages against the broker-dealer's accountant for various state law causes of action. *SIPC v. BDO Seidman,* LLP, 49 F. Supp. 2d 644, 646 (S.D.N.Y. 1999). Chief Judge Preska found that, *inter alia*, the SIPA trustee had standing to bring suit on behalf of the broker-dealer's customers as a bailee. *Id.* at 654. In so holding, Chief Judge Preska reasoned that "[w]hen the Supreme Court reversed the Court of Appeals, it did not disturb" the Second Circuit's holding that a SIPA trustee could assert claims on behalf of customers who were not fully reimbursed by SIPC as bailee of customer property. *Id.* at 652. Chief Judge Preska found she was "bound by *Redington* to hold that the Trustee can bring suit as bailee." *Id.* at 654. On appeal, when discussing whether it would be justified in revisiting *Redington*, the Second Circuit acknowledged that "[t]his court is bound by a decision of a prior panel unless and until its rationale is overruled, implicitly or expressly, by the Supreme Court or this court *en banc*." *BDO Seidman*, 222 F.3d at 69 (quoting *Sokolowski*, 205 F.3d at 534–35).

JPMC contends, citing to the *HSBC* decision, that *Redington* is no longer binding authority, arguing that because the Supreme Court held that there was no private right of action under § 17(a), the Court effectively "held that the Second Circuit erred in reaching the issue of whether the SIPA trustee had implied standing to bring" a claim under that section. (Def. Br. 14.)

This is an incorrect proposition of law. A trustee's standing is a question of subject-matter jurisdiction—whether the trustee has been injured such that a "case or controversy" exists. *Breeden v. Kirkpatrick & Lockhart LLP* (*In re Bennett Funding Grp., Inc.*), 336 F.3d 94, 101–02 (2d Cir. 2003); *see also Nnebe v. Daus*, 644 F.3d 147, 156 (2d Cir. 2011) ("Standing is the threshold question in every federal case, determining the power of the court to entertain the suit.") (internal quotations omitted). A court always has jurisdiction to determine its jurisdiction. *See Rhodes-Bradford v. Keisler*, 507 F.3d 77, 81 (2d Cir. 2007) ("It is, of course, the case that we have jurisdiction to determine whether or not we have jurisdiction over a matter."). Thus, the Second Circuit in *Redington* had jurisdiction to decide the standing decisions when it did. The fact that the Supreme Court ultimately determined that the particular cause of action asserted under § 17(a) was not available—a merits question, not a jurisdictional one—has no bearing on the preliminary jurisdictional standing determination. *See Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (noting the scope of § 10(b) of the Securities and Exchange Act is a merits question, not one of subject matter jurisdiction).

Nor did the Second Circuit's decision on remand affect its original holding on standing. The Second Circuit had subject matter jurisdiction to determine whether the SIPA trustee had Article III standing. On remand, this jurisdictional question was not before the court, having already been settled, and the purported federal claim had been determined on the merits not to be viable. The court proceeded to the remaining jurisdictional issues, and, finding no diversity and that there was no longer a federal claim for relief, it dismissed the remaining state law claims, effectively declining to retain pendent jurisdiction over them. *Redington v. Touche Ross & Co.*, 612 F.2d 68, 70 (2d Cir. 1979).

JPMC relies on *Newdow v. Rio Linda Union School District*, 597 F.3d 1007, 1041 (9th Cir. 2010), to advance its theory that *Redington* is no longer good law. (Def. Br. 15.) *Newdow* stands for the proposition that when the Supreme Court reverses a lower court's decision on the threshold question of lack of jurisdiction, the merits determinations are not precedential. 597 F.3d at 1041. That is because "a district court must generally resolve material factual disputes and establish that it has federal constitutional jurisdiction, including a determination that the plaintiff has Article III standing, before deciding a case on the merits." *Alliance For Envtl. Renewal, Inc. v. Pyramid Crossgates Co.*, 436 F.3d 82, 85 (2d Cir. 2006) (internal citations omitted). But in *Redington*, the Supreme Court's reversal was on the merits; the question of standing, itself jurisdictional, was not affected.

The Supreme Court's reversal of a decision on one ground does not negate the precedential effect of a lower court opinion in other respects. For example, in *Best Van Lines, Inc. v. Walker*, 490 F.3d 239, 247 n.10 (2d Cir. 2007), the Second Circuit cited as precedential authority its holding in *Padilla v. Rumsfeld*, 352 F.3d 695, 709 (2d Cir. 2003), *rev'd on other grounds*, 542 U.S. 426 (2004), for *Padilla*'s interpretation of the New York long-arm personal jurisdiction statute, despite the fact that the Supreme Court held, when reversing *Padilla*, that Padilla could be sued only in the jurisdiction of his confinement, not New York. *Padilla*, 542 U.S. at 496. Similarly, in *Wickham Contracting Co. v. Local Union No. 3, International Brotherhood of Electrical Workers, AFL-CIO*, 955 F.2d 831, 835 (2d Cir. 1992), the Second Circuit cited as precedential authority its holding in *Trans World Airlines, Inc. v. Hughes*, 449 F.2d 51, 80 (2d Cir. 1971), *rev'd on other grounds*, 409 U.S. 363 (1973), for the proposition that prejudgment interest is not available in antitrust cases where treble damages are awarded, despite the fact that the Supreme Court held, when reversing *Trans World Airlines*, that the defendant had immunity under the antitrust laws. *Trans World Airlines*, 409 U.S. at 386, 388–89. In both *Best Van Lines* and *Wickham*, the Second Circuit cited as binding precedent propositions of law set forth in prior cases that were reversed on other grounds, even though the propositions for which they were cited would never have been reached had the Second Circuit decided a preliminary issue in the manner in which the Supreme Court did.[4]

It is only when a judgment is vacated, as opposed to when it is reversed on other grounds, that the decision below lacks precedential effect. *See Brown v. Kelly*, 609 F.3d 467, 476–77 (2d Cir. 2010) ("A decision may be *reversed* on other grounds, but a decision that has been *vacated* has no precedential authority whatsoever.") (emphasis in original) (quoting *Durning v. Citibank, N.A.*, 950 F.2d 1419, 1424 n.2 (9th Cir. 1991)); *Cnt. Pines Land Co. v. United States*, 274 F.3d 881, 894 n.57 (5th Cir. 2001) ("While our prior opinion in *Leiter Minerals II* did not bind the *Little Lake* panel because it was *vacated*, the opinion in *Little Lake* binds us because only the *judgment* was reversed on other grounds.") (emphasis in original). Here, the Supreme Court did not vacate the Second Circuit's judgment. *Redington*, 442 U.S. at 579. Rather, the Supreme Court reversed on other grounds, without reaching the Second Circuit's separate holding that a SIPA trustee and SIPC have standing to bring causes of action as bailee and subrogee, respectively. *See id*. at 578–79.

[4] To counter this argument, JPMC relies on *Brecht v. Abrahamson*, 944 F.2d 1363, 1370 (7th Cir. 1991). But *Brecht* is inconsistent with how the Seventh Circuit generally treats the precedential value of its own decisions that have been reversed on other grounds—namely, just as the Second Circuit does. For example, in *Muscarello v. Ogle County Board of Commissioners*, 610 F.3d 416, 426 (7th Cir. 2010), decided well after *Brecht*, the Seventh Circuit cited *Littleton v. Berbling*, 468 F.2d 389, 394 (7th Cir. 1972), *rev'd on other grounds, O'Shea v. Littleton*, 414 U.S. 488 (1974), to describe the scope of a court's discretion not to dismiss a matter for lack of subject matter jurisdiction when jurisdiction exists but is not properly pleaded—even though the Supreme Court in *Littleton* ultimately held that subject matter jurisdiction did not exist in that case.

Mishkin and *HSBC* improperly ignore *BDO Seidman* and the precedential value of *Redington*. The Supreme Court's decision did not "wipe[] out everything that . . . occurred up to that time." (Def. Br. 16–17) (citing *Mishkin* transcript and *HSBC*, 2011 WL 3200298, at *7–8.) The precedential value of the *Redington* decision remains intact, and *Mishkin* and *HSBC* are outliers. The Sixth Circuit remarked that *Mishkin* "departed from the precedent of its circuit." *Appleton v. First Nat'l Bank of Ohio*, 62 F.3d 791, 799–800 (6th Cir. 1995).

b. The *HSBC* Court's Rationales for why *Redington* Lacks Effect Are Unavailing

The Trustee respectfully disagrees with the reasoning in the *HSBC* decision as to why *Redington* may be ignored.

First, *HSBC* distinguished *Morrison* on the ground that it involved a determination of the scope of the Securities and Exchange Act, which is a merits question, stating that *Morrison* "concerned whether an accepted cause of action brought under § 10(b) was properly pled, not whether a right of action existed at all." (*HSBC*, 2011 WL 3200298, at *11 n.7.) Justice Scalia, however, expressly stated that the Supreme Court granted *certiorari* to decide "whether § 10(b) of the Securities Exchange Act of 1934 *provides a cause of action* to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges." *Morrison*, 103 S. Ct. at 2875 (emphasis added).

Second, the language quoted from *National Railroad Passenger Corp.* in *HSBC* does not stand for the proposition that standing never can be considered and decided as a separate threshold issue apart from the existence of a particular right of action. *See HSBC*, 2011 WL 3200298, at *11 n.7 ("'[it is only if such a [private] right of action exists that we need consider whether the respondent had standing . . .'") (alterations in original). In *National Railroad*, the Supreme Court noted that whether a private right of action was created by the Amtrak Act and whether the respondent had standing to bring it were in that case virtually the same question, or at least, inextricably overlapping. *Nat'l R.R. Passenger Corp. v. Nat'l Ass'n of R.R. Passengers*, 414 U.S. 453, 456–57 (1974). That is not the case here. *Redington* held that the SIPA trustee can sue any wrongdoer whom the customers could sue themselves for any cause of action that the customers could bring themselves. *Redington*, 592 F.2d at 625. This question is different from that of whether the particular claim asserted by the trustee in that action exists. The Second Circuit addressed the question of whether the SIPA trustee is a bailee of customer property and whether SIPC is a subrogee before—and independently of—whether § 17 created a private right of action.

3. The Trustee is the Representative of the Fund of Customer Property

a. The Bailment is Created by Operation of Law

The Trustee brings the common law claims against JPMC "as representative of, and as bailee of, the Customer Property estate." (Am. Compl. ¶ 20(f).) Consistent with *Redington*, this status may be viewed as a bailment relationship arising by operation of law. *See Seaboard Sand & Gravel Corp. v. Moran Towing Corp.*, 154 F.2d 399 (2d Cir. 1946); *Fada Indus. v. Falchi Bldg. Co., L.P.*, 730 N.Y.S.2d 827 (Sup. Ct. 2001).

The fundamental elements of a bailment are (1) "lawful possession, however created," and (2) the "duty to account for the thing as the property of another. . . ." *Foulke v. N.Y. Con. R.R. Co.*, 228 N.Y. 269, 275 (1920). SIPA thus creates this relationship by entrusting the fund of customer property to the SIPA trustee and bestowing upon him the duty to marshal and return such property to the customers. Based on his lawful possession, a bailee has a special property interest—a possessory interest—in the bailment that, under the law of bailment, is sufficient to give the bailee the right to sue third parties for damage or loss caused to the property. *Paragon Oil Co. v. Republic Tankers, S.A.*, 310 F.2d 169, 175 (2d Cir. 1962). The Second Circuit's decision in *Redington* is thus rooted in SIPA and its creation of a relationship between a SIPA trustee and the fund of customer property, as well as in the law of bailment, which describes the rights and powers of the SIPA trustee by virtue of that relationship.

This bailment exists independently of the Trustee's other capacity as representative of, or successor to, BLMIS. Rather, the bailment is predicated on the Trustee's exclusive possession of the fund of customer property and his status as representative of the separate customer property estate pursuant to SIPA. *See In re BLMIS*, 2011 WL 3568936, at *3 ("In a SIPA Liquidation, a fund of 'customer property,' separate from the general estate of the failed broker-dealer, is established. . . ."); *Rosenman*, 395 F. App'x at 768 (explaining that the "customer property estate . . . is separate from the general estate used to satisfy the claims of general unsecured creditors").

Thus, SIPA trustees wear two hats, vindicating the interests of two separate estates—the general estate (as a bankruptcy trustee) and the customer property estate. "Generally, SIPA liquidations involve two kinds of claimants: customers and general unsecured creditors. To protect customers of failed brokerages, their claims are satisfied from a customer property estate, which is separate from the general estate used to satisfy the claims of general unsecured creditors." *Rosenman*, 395 Fed. App'x at 768 (citing *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 270 (Bankr. S.D.N.Y. 1996)).

JPMC argues that the absence of the term "bailment" on the face of the statute proves *ipse dixit* that SIPA does not create a bailment relationship. (Def. Br. 14.) This argument is unavailing. A bailment is a way to characterize a relationship between two parties. The word "bailment" also does not appear on the claims ticket when one checks one's clothes at the dry cleaner. However, the law describes the rights and duties of parties that stand in relationships to one another; the absence of the word does not change the nature of the relationship SIPA creates between the Trustee and the fund of customer property.

b. The *HSBC* Court's Distinctions Concerning the Bailment Relationship Are Mistaken

JPMC contends, and the *HSBC* court reasoned, that because Madoff, as a thief, could never be a bailee, the Trustee as his successor-in-interest, cannot be a bailee. (Def. Br. 17;) *HSBC*, 2011 WL 3200298, at *5. However, the Trustee's capacity as representative of the fund of customer property is unaffected by any intention of Madoff to misappropriate funds deposited by investors in BLMIS. This relationship is not created between the customers and BLMIS (or by any agreement), but by operation of SIPA—by entrusting the separate fund of customer property to the Trustee's care for return to the customers.[5] *See Seaboard Sand & Gravel*, 154 F.2d at 402; *Fada Indus.*, 730 N.Y.S.2d at 839–40. This relationship is a bailment created by law, a form of trust, which arises from the situation in which SIPA places the parties. It is, in turn, the Trustee's lawful possessory interest that provides the basis for the Trustee's right to sue JPMC for damages.

Moreover, in *HSBC*, the court stated that "the purported breach is alleged to have occurred prior to the bailment, since the [defendants] are alleged to have poured money into Madoff Securities." *HSBC*, 2011 WL 3200298, at *8. This reasoning misses the fundamental point that it is the Trustee who is entrusted with the fund of customer property by SIPA. He does not acquire it through succession to BLMIS, nor does his status depend on BLMIS's relationship to its customers or to customer property. Moreover, under the SIPA scheme, the Trustee's status as representative of the fund of customer property is explicitly retroactive in scope. SIPA

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[5] SIPC argues in its brief that the bailment can alternatively be viewed as a creature of federal common law.

anticipates the fraudulent activities of agents such as Madoff, by defining customer property to include cash "at any time received," including property "unlawfully converted." 15 U.S.C. § 78*lll*(4). SIPA itself is thus predicated on the fundamental principle that the customers of a broker-dealer never lose ownership of customer property, regardless of whether it is improperly commingled or converted while in the hands of the broker-dealer. The fund of customer property, and the Trustee's role as representative, necessarily look back at the events and circumstances that led to the failure of the broker-dealer, in order to maximize customer property and vindicate his interest in the fund.

The *HSBC* court also stated that the Trustee is not a bailee because "he is not seeking to 'return any recovered bailments to the individual bailors,' as a bailee would, but instead is seeking to distribute customer property pro rata pursuant to the SIPA distribution scheme." *HSBC*, 2011 WL 3200298, at *5. However, the Trustee is seeking to do precisely what a bailee would do in these circumstances: recover damages for harm to the property, which he holds in trust for the benefit of the bailors. *See Rogers v. Atlantic, Gulf & Pac. Co.*, 213 N.Y. 246, 258 (1915).

The Trustee submits that *HSBC*'s observation that *Redington* dealt with a trustee's and SIPC's right to bring claims under § 17 of the Exchange Act, as opposed to common law claims, is a distinction without a difference. The Court in *Redington* held that the SIPA trustee could sue "any wrongdoer whom [the customers] could sue themselves." *BDO Seidman*, 222 F.3d at 71 (quoting *Redington*, 592 F.2d at 625). Under the law of bailment, the bailee's possessory interest entitles him to bring any claim for damage or loss to the bailed property. There is no rationale for the conclusion that *Redington* somehow limited the trustee's standing as bailee to claims under § 17 of the Exchange Act. *HSBC* noted that common law claims differ from federal statutory claims in that they "generally require proof of individual reliance and causation, which may pose justiciability concerns in the context of a mass tort action by a SIPA trustee." *HSBC*, 2011 WL 3200298, at *8. However, there seems little basis for distinguishing the "justiciability" of common law claims—by which the *HSBC* court seems to have meant their ability to be fairly and efficiently adjudicated *en masse*—from claims under § 17 of the Exchange Act, especially because as bailee, the SIPA trustee sues for harm to customer property in both instances. Nor does the manner in which claims will be adjudicated have anything to do with standing.

The *HSBC* court's statement that *Redington* was more analogous to "a traditional bailor-bailee scenario" ignores *Redington's* reliance on a trustee's duty to marshal and return customer property under SIPA. *HSBC*, 2011 WL 3200298, at *8; *see also Redington*, 592 F.2d at 625. In *Redington*, the court described the relationship between the SIPA trustee and customer property and the powers of the trustee that arise from that relationship. Insofar as the SIPA trustee's traditional bailor-bailee scenario is concerned, *Redington* determined that this legal doctrine of bailment appropriately should be applied in the context of a SIPA trustee.

The *HSBC* court also found that *Redington* was inapplicable because HSBC did not provide direct services to BLMIS, unlike the accountant and broker-dealer in *Redington*. Although that is not a dispositive distinction, it has no application in this case, as JPMC was Madoff's and BLMIS's primary banker.

c. As Bailee and Representative of the Fund of Customer Property, the Trustee Can Recover Damages for the Benefit of the Fund

SIPA contemplates that a trustee may recover damages. First, customer property includes not only property fraudulently transferred but also "the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. § 78*lll*(4). Given a broad reading of SIPA, damages caused by JPMC's participation in perpetuating the Ponzi scheme are reasonably subsumed within the concept of "proceeds" of "unlawfully converted" property. Moreover, SIPA expressly contemplates that a trustee may recover more in the customer property estate than is needed to satisfy customers' net equity claims, belying the notion that actions to recover customer property are limited to seeking amounts fraudulently transferred. *See* 15 U.S.C. § 78fff-2(c) ("Any customer property remaining after allocation in accordance with this paragraph shall become part of the general estate of the debtor.").

It would be impossible to predict *ex ante* whether avoidance actions alone would recover funds necessary to satisfy customers' net equity claims. Accordingly, the trustee must have additional authority to pursue claims beyond the quantum of avoidable transfer claims to augment the customer property estate and the court should construe the statute liberally to accomplish its purpose.[6]

B. The Trustee Has Standing to Assert SIPC's Subrogation Rights Arising From SIPC Advances

The Trustee also has standing to assert subrogation claims belonging to SIPC, through SIPC's assignment of its subrogation rights to the Trustee.

1. The Trustee's Subrogation Rights Stem From Equity and SIPA

Under the law of equitable subrogation, where one party (SIPC) discharges an obligation owed by another (BLMIS), such that the latter would be unjustly enriched by the retention of the benefit thus conferred, the former is subrogated to the position of the person to whom the obligation is owed (BLMIS's customers). *Elwood v. Hoffman*, 61 A.D.3d 1073, 1075 (3rd Dep't

[6] This Court is empowered to exercise its discretion under prudential standing to allow the Trustee to proceed. Prudential theories of standing are judicially created and so long as a litigant has been found to have Article III standing—which the Trustee does—it is within the court's discretion to decide whether to apply prudential limitations on standing to a particular case. *See United Food & Commercial Workers Union Local 751 v. Brown Grp., Inc.*, 517 U.S. 544, 551 (1996).

2009). Courts favor the application of subrogation, and have extended rather than restricted its application. *3105 Grand Corp. v. City of N.Y.*, 288 N.Y. 178, 182 (1942); *Menorah Nursing Home, Inc. v. Zukov*, 153 A.D.2d 13, 18 (2d Dep't 1989). The Second Circuit held that SIPC has equitable subrogation rights. *See Redington*, 592 F.2d at 624. The court ruled that its holding was "more keeping with the intent of Congress that wrongdoers not receive a windfall benefit from the existence of SIPC, and that SIPC be able to recoup its losses from solvent wrongdoers." *Id.*

SIPC's subrogation rights stem not only from equity, but from the statute itself. While the version of SIPA at play in *Redington* did not contain statutory provisions that included subrogation rights as against third parties, significantly, the statute was later amended. When *Redington* was decided, then-SIPA § 78fff(A)(1) *expressly* limited SIPC's subrogation rights to "customers' claims against the debtor's . . . estate." *Id.*; *see* Act of May 21, 1978, Pub. L. 95–283 § 8, 92 Stat. 249 (codified at 15 U.S.C. § 78aaa, *et seq.*). After *Redington*, however, Congress replaced that section of the statute with § 78fff-3(a), which does not contain this limitation. Section 78fff-3(a) states, in relevant part:

> To the extent moneys are advanced by SIPC to the trustee to pay or otherwise satisfy the claims of customers, in addition to all other rights it may have at law or in equity, SIPC shall be subrogated to the claims of such customers with the rights and priorities provided in this chapter, except that SIPC as subrogee may assert no claim against customer property until after the allocation thereof to customers as provided in section 78fff–2(c) of this title.

15 U.S.C. § 78fff-3(a). The removal of the express limiting language indicates Congress's intent to expand SIPC's subrogation rights.

Thus far, the Trustee has distributed approximately $800 million to customers from funds advanced to him by SIPC. In advancing these funds, SIPC has retained subrogation rights to pursue those responsible for the amount it spent to compensate customers for their losses. As a subrogee, SIPC has the right to assert claims against third parties in place of those customers to whom SIPC has advanced funds. *See Redington*, 592 F.2d at 624; *see also BDO Seidman*, 222 F.3d at 69; *In re Park S.*, 326 B.R. at 515–16; *Giddens v. D.H. Blair & Co.* (*In re A.R. Baron & Co.*), 280 B.R. 794, 805 (Bankr. S.D.N.Y. 2002). SIPC has conferred its subrogation rights onto the Trustee and, thus, the Trustee has standing to assert the common law claims against JPMC as a subrogee. (*See* Am. Compl. ¶ 20(h);) *see also In re Park S.*, 326 B.R. at 515–16.

2. *HSBC* Incorrectly Held That the Trustee Lacked Standing on the Basis of Subrogation

JPMC relies on *Mishkin*, 744 F. Supp. 531 and the *HSBC* decision, both of which ignore binding Second Circuit precedent and misapply the law of subrogation. (Def. Br. 19–21.) The Court in *Mishkin* disagreed with the Second Circuit's analysis that SIPC advances could create rights of equitable subrogation because SIPA "was not intended to be an insurance-type statute" and "application of insurance principles of subrogation is seemingly inappropriate." 744 F. Supp. at 557–58. This holding misconceives the statute; subrogation is a doctrine of equity and is not limited to "insurance principles." *See, e.g., Perez v. Fiore*, 912 N.Y.S.2d 118, 120 (2d Dep't 2010) (citing *Gerseta Corp. v. Equitable Trust Co. of N.Y.*, 241 N.Y. 418, 425–26 (1926) (applying equitable subrogation outside of insurance context)); *Gerow v. Sinay*, 905 N.Y.S.2d 827, 833–34 (Sup. Ct. Onondaga County 2010) (citing *King v. Pelkofski*, 20 N.Y.2d 326, 333–34 (1967)). Subrogation rights exist under long-recognized equitable principles and can be circumscribed by statute only if done expressly. *See, e.g., Lorillard*, 533 U.S. at 541–42 (holding that federal preemption of state law rights must be "clear and manifest"). SIPA does not circumscribe SIPC's equitable subrogation rights. In fact, it does precisely the opposite; in granting to SIPC *statutory* subrogation rights, it expressly provides that such rights are "in addition to all other rights it may have at law or in equity." 15 U.S.C. § 78fff-3(a).

HSBC held that SIPC cannot be equitably subrogated to customers' claims against third parties because that right would subvert SIPA's distribution scheme, as SIPC would recover before customers. *HSBC*, 2011 WL 3200298, at *6. *HSBC* is incorrect and contrary to the basic principle that equitable subrogation is not to be restricted in its application. *See, e.g.*, *3105 Grand Corp.*, 42 N.E.2d at 477. SIPC's right arises as a matter of equity, because it was required to pay obligations that were owed in part by third-party wrongdoers. It is unreasonable to read SIPA's distribution scheme as "conflicting" with SIPC's equitable right. Instead, the two should be harmonized to the extent possible, with SIPA simply modifying the timing and mechanics of SIPC's recovery to the extent necessary. *See Bates v. Dow Agrosciences LLC*, 544 U.S. 431, 449 (2005) (holding that when a statute is susceptible to more than one plausible reading, the court has "a duty to accept the reading that disfavors pre-emption").[7]

C. The Trustee Has Standing to Bring Claims Assigned to Him by BLMIS Customers

The Trustee has not yet received assignments from any customers. (*See* Am. Compl. ¶ 20.) Thus, while this issue may not yet be ripe for adjudication, because JPMC has raised the issue, the Trustee addresses it.

1. The Second Circuit Held in *CBI* That Creditors Can Assign Causes of Action to a Bankruptcy Trustee

In *CBI*, the Second Circuit held that an appointed disbursing agent for the debtor's reorganization plan had standing to assert assigned claims. The Second Circuit reasoned that "[a]llowing a debtor's creditors to assign their claims for the benefit of the debtor's estate permits debtors, creditors, and bankruptcy courts the flexibility in reorganizing or liquidating a

[7] Moreover, there is no conflict with SIPA's provision allocating customer property. 15 U.S.C. § 78fff-2(c)(1). As equitable subrogee, to the extent of its advances, SIPC is subrogated to customers' claims against third party wrongdoers and is entitled to recover in that capacity.

debtor's assets necessary to achieve efficient administration of the reorganization or liquidation." 529 F.3d at 459. *CBI* held that a bankruptcy trustee's power to take assignments stems from § 541(a)(7) of the Bankruptcy Code. *Id.* at 456–59.

Numerous other courts have reached the same conclusion. *See, e.g.*, *Semi-Tech Litig.*, 272 F. Supp. 2d at 323–24; *Bogdan v. JKV Real Estate Servs.* (*In re Bogdan*), 414 F.3d 507, 511–12 (4th Cir. 2005). In determining that a bankruptcy trustee had standing to assert common law claims against the debtor's co-conspirators as the assignee of certain creditors' claims, the Fourth Circuit in *Bogdan* explained a trustee's authority to bring these claims:

> The trustee is specifically authorized to "collect and reduce to money *the property of the estate* for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest." . . . "*[P]roperty of the estate" under § 541*(*a*) *has "uniformly been interpreted to include causes of action."* . . . [and, under § 541(a)(7)] also includes "any interest in property that the estate acquires after the commencement" of a bankruptcy case. Thus, the unconditional assignments acquired by [the] trustee from the [debtor's creditors] after commencement of this bankruptcy case constitute "property of the estate" that the trustee is authorized to "collect and reduce to money" on behalf of the estate." . . . *Accordingly, the trustee has the requisite standing to sue [the debtor's] alleged coconspirators "to collect and reduce to money" the causes of action he acquired* . . . .

In re Bogdan, 414 F.3d at 512 (emphasis added) (internal citations omitted).

Significantly, the portion of the Bankruptcy Code—§ 541(a)(7)—that empowers bankruptcy trustees to take assignments is expressly incorporated into the SIPA statute. 15 U.S.C. § 78fff(b). The SIPA statute need not explicitly provide for a power where the power is incorporated through the Bankruptcy Code. *BDO Seidman*, 222 F.3d at 69.

2. JPMC Ignores *CBI*

Ignoring the Second Circuit's decision in *CBI*, JPMC cites to district court cases that preceded that decision and, accordingly, never considered a SIPA trustee's standing under § 541(a)(7). (*See* Def. Br. 22; *HSBC*, 2011 WL 3200298, at *9.) The cases JPMC cites only analyze a trustee's standing under SIPA. *See In re Park S.*, 326 B.R. at 515 (relying solely on the SIPA statute to determine a trustee did not have standing to bring customer claims against third parties); *BDO Seidman*, 49 F. Supp. 2d at 654 n.7 (declining to construe SIPA "so broadly as to permit standing" to bring suit against third parties as a result of assignments); *In re A.R. Baron*, 280 B.R. at 802–03 (limiting claims that customers can assign to a trustee to only the customers' net equity claims and not claims against the defendants); *Mishkin*, 744 F. Supp. at 554–55 (finding that SIPA did not empower the trustee to accept assignments from financial institutions).

Under *CBI*, the Trustee possesses the same abilities as a typical bankruptcy trustee to bring claims as an assignee. *See* 529 F.3d at 459.

IV. *WAGONER* AND *IN PARI DELICTO* ARE INAPPLICABLE TO THE TRUSTEE'S CLAIMS

The *Wagoner* Rule and the doctrine of *in pari delicto* do not apply to the Trustee's claims against JPMC. *Wagoner* and its progeny were cases brought under § 541, and emanate from the principle that a trustee's powers under § 541 are no greater than those of the debtor that preceded it, so that if a malfeasant debtor could not proceed against a third party under the principle of *in pari delicto*, neither could the trustee. *See Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991). The *in pari delicto* defense is based on the principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).[8]

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[8] *In pari delicto* is an equitable affirmative defense under New York law, and should not be considered on a motion to dismiss for lack of standing. *See Kirschner*, 938 N.E.2d at 950. The Court in *Wagoner* applied *in pari delicto* principles in holding that the trustee lacked standing to sue third parties, but this was not well-founded in New York law, which should have governed the issue. *See In re Magnesium Corp.*, 399 B.R. at 763 (recognizing "state law underpinnings" of *Wagoner* "are thin") (citing *Barnes v. Schatzkin*, 212 N.Y.S. 536 (1st Dep't 1925), *aff'd*, 242 N.Y. 555.

A. *In Pari Delicto* and The *Wagoner* Rule Do Not Apply to the Trustee's Contribution Claim

JPMC's argument that the Trustee's contribution claim is barred under *in pari delicto* and the *Wagoner* rule has no merit. (Def. Br. 65 n.13.) Parties seeking contribution are necessarily *in pari delicto*. *See HSBC*, 2011 WL 3200298, at *10; *Barrett v. United States*, 853 F.2d 124, 128 n.3 (2d Cir. 1988); *Rotter v. Leahy*, 93 F. Supp. 2d 487, 496 (S.D.N.Y. 2000). Accordingly, the Trustee's contribution claim cannot be blocked by *in pari delicto* and the *Wagoner* rule.

B. Neither *Wagoner* nor *In Pari Delicto* Bars the Trustee's Claims Brought Under § 544

When the Trustee exercises his rights under § 544(a), he stands in the shoes of a hypothetical judgment creditor "without regard to any knowledge of the trustee or any creditor."[9] Accordingly, when actions are brought under § 544, *in pari delicto* does not apply. This principle holds true even when the judgment creditor has appropriated a debtor's cause of action which might otherwise be barred by *in pari delicto*, because § 544(a) provides a trustee with federal statutory standing as an innocent creditor. *See In re Flanagan*, 373 B.R. 216, 229–30 (D. Conn. 2007) (trustee's successor-in-interest's alter ego and constructive trust claims, barred by *in pari delicto* if brought under § 541, not barred by *in pari delicto* if brought under § 544(a)); *Gibson Dunn*, 2007 WL 2669150, at *15 ("wrongdoing of the debtor is not imputed to the trustee when acting in his capacity as a representative of creditors under § 544(a)"); *Sender v. Mann*, 423 F. Supp. 2d at 1174 ("[*In pari delicto*] applies to claims a bankruptcy trustee brings as a debtor, but not as a representative of creditors, since creditors are not culpable for the misconduct of the corporate entity. This doctrine therefore does not bar [trustee's] claims brought on behalf of creditors, either by assignment or under the authority of § 544(a)."); *Porter*

[9] *See CBI*, 529 F.3d at 456 ("*Wagoner* specifically leaves open the question of when a bankruptcy trustee can assert claims on behalf of a debtor's creditors.").

McLeod, 231 B.R. at 794 ("[I]n bankruptcy, [*in pari delicto*] applies only to the trustee in his 'debtor' status, not as 'creditor.'"); *see also MacMenamin's Grill Ltd.*, 450 B.R. at 431 (*Wagoner* Rule and *in pari delicto* do not apply to a trustee "who has independent standing under section 544"); *Podell & Podell v. Feldman* (*In re Leasing Consultants Inc.*), 592 F.2d 103, 110–11 (2d Cir. 1979) (allowing trustee to pursue claims on behalf of creditors under § 544's predecessor "does not undercut the purpose of the doctrine of *in pari delicto*"); *In re Park S. Sec., LLC*, 326 B.R. 505, 515 (Bankr. S.D.N.Y. 2005) ("given such statutory standing, such a claim [for unjust enrichment] would not be subject to any aspect of the *Wagoner* Rule"); *Tolz v. Proskauer Rose LLP* (*In re Fuzion Tech. Grp., Inc.*), 332 B.R. 225, 232 (Bankr. S.D. Fla. 2005) ("courts have found that the *in pari delicto* defense is inapplicable when a trustee brings an action under §§ 544(a), 544(b), or 548, but the defense applies under § 541"); *C-T of Va., Inc. v. Painewebber, Inc.* (*In re C-T of Va., Inc.*), No. 90-1557, 1991 WL 138489, *6 (4th Cir. July 30, 1991) (malfeasance of debtor does not limit right of creditors in avoidance actions under § 544); *Wedtech Corp. v. Nofziger* (*In re Wedtech*), 88 B.R. 619, 622 (Bankr. S.D.N.Y. 1988) ("a trustee's ability to obtain a recovery for an estate and its blameless creditors may not be denied by the pre-petition wrongful conduct of the debtor"); *Gower v. Farmers Home Admin.* (*In re Davis*), 785 F.2d 926, 927 (11th Cir. 1986) ("[s]ince the trustee's claims are for the benefit of the creditors, the fraud of the bankrupt does not require them to be forfeited"); *Faircloth v. Paul* (*In re Int'l Gold Bullion Exch., Inc.*, 60 B.R. 261, 264 (Bankr. S.D. Fla. 1986) (trustee's "strong arm" powers not forfeited because of the debtor's fraud); *Hassett v. McColley* (*In re O.P.M. Leasing Serv., Inc.*), 28 B.R. 740, 760–61 (Bankr. S.D.N.Y. 1983) ("trustee's right to recover payments made by the debtor not barred by prepetition wrongful conduct of the debtor").[10]

[10] Indeed, if *in pari delicto* was read to bar all actions on behalf of creditors, it would also bar

Moreover, under New York law, a trustee standing in the shoes of a creditor may assert claims that the debtor would otherwise be precluded from bringing. *See Pittsburgh Carbon Co. v. McMillin*, 119 N.Y. 46, 53 (1890) (trustee of insolvent company, acting on behalf of creditors, may "disaffirm dealings of the corporation in fraud of the creditor's rights"); *Cent. Hanover*, 105 F.2d at 131–32 (L. Hand, J.) ("there are occasions when [a trustee] may represent creditors when the defendant would have had no standing") (citing *Pittsburgh Carbon*, 119 N.Y. at 53). "[I]t would be a very strange application of the [*in pari delicto*] doctrine that no right of action can spring from an illegal transaction, which should deny to innocent creditors of the combination, or to the receiver who represents them, the right to have the debt collected and applied in satisfaction of their claim." *Pittsburgh Carbon*, 119 N.Y. at 53.

Indeed, to apply *Wagoner* here would lead to absurd results. *Wagoner* stands for the proposition that claims against third parties involving debtor malfeasance accrue to creditors, not the Trustee. But under § 544, the Trustee is statutorily empowered to bring such claims on behalf of a hypothetical judgment creditor, to which *in pari delicto* has no application. Indeed, under *St. Paul*—which preceded *Wagoner*—creditor claims asserting generalized harm are *exclusively* to be asserted by the Trustee. *Wagoner* and *St. Paul* can be harmonized if, as the *St. Paul* court held, the Trustee has the right to vindicate creditors' interests asserting generalized harm under § 544.

avoidance actions under § 544(b), but courts have uniformly rejected attempts to bar a trustee's avoidance actions under that provision. No logical distinction can be made between § 544(a) and § 544(b) as to the inapplicability of *in pari delicto*, as they both involve the assertion of state-law claims in connection with the trustee's status as creditor, not debtor.

C. *In Pari Delicto* Does Not Apply to Actions by the SIPA Trustee as Bailee of the Customer Property Estate

JPMC contends that the concepts of *in pari delicto* and the *Wagoner* Rule bar the Trustee from bringing his common law claims as bailee. (Def. Br. 9–11.) However, these concepts have no application to a SIPA trustee acting on behalf of a customer property estate.

The customer property estate comprises property that is not and was never property of the debtor. This is because a broker has a duty to segregate customer funds from the broker's own funds. "It is important to bear in mind that the single and separate fund is not composed of assets of the debtor, but rather, property of the *customers*." *Albert & Maguire*, 560 F.2d at 579 (emphasis added); *Picard v. Chais* (*In re Bernard L. Madoff Inv. Sec.*), 445 B.R. 206, 237–38 (Bankr. S.D.N.Y. 2011) ("In a SIPA proceeding, however, property held by a broker-debtor for the account of a customer is not property of the broker-debtor."). Customer property is deemed to be property of the debtor for a single limited purpose—so that a SIPA trustee can prosecute bankruptcy avoidance actions, which must be done on behalf of the debtor. *See* 15 U.S.C. § 78fff-2(c)(3); *Hill v. Spencer Sav. & Loan Ass'n* (*In re Bevill, Bresler & Schulman, Inc.*), 94 B.R. 817, 825–26 (D.N.J. 1989) (§ 78fff–2(c)(3) creates a legal fiction by deeming customer property to be property of the debtor, relieving SIPA trustee from having to prove that the property belonged to the debtor's estate); *Chais*, 445 B.R. at 238 (collecting cases). For any other action that a SIPA trustee can bring that fiction does not apply as the Trustee brings that action not on behalf of the debtor, but on behalf of the customer property estate.

As a SIPA trustee is specifically charged with accumulating customer property for the customer property estate, *Wagoner*'s limitation of a *bankruptcy* trustee's authority to actions on behalf of the debtor has no bearing here. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995), which follows *Wagoner*, is similarly inapposite.

V. SLUSA DOES NOT BAR THE TRUSTEE'S CLAIMS

JPMC asks this Court to do something extraordinary—to use the Securities Litigation Uniform Standards Act ("SLUSA") to stop a federal court-appointed liquidation trustee from fulfilling his statutorily-mandated obligations under the Bankruptcy Code and SIPA. SLUSA was designed to prevent the circumvention of federal securities laws by class action plaintiffs bringing state law-based securities claims. It has no application here. SLUSA cannot be used to preempt the efforts of a bankruptcy trustee, as those efforts are excluded from SLUSA's reach by an entity exception written into the statute itself. This reflects Congress's concern at the time of its enactment that while claims brought by bankruptcy trustees may benefit more than fifty creditors of a bankrupt entity, they should not be subject to SLUSA preemption because they were not the intended target of the statute. Simply put, bankruptcy trustees are not class action plaintiffs. JPMC asks this Court to ignore the critical distinction between claims *brought* by more than fifty individuals, which are the focus of SLUSA, and claims which merely *benefit* more than fifty individuals, which are protected from preemption by the entity exception written within SLUSA.

SLUSA was enacted to prevent the circumvention of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Specifically, SLUSA preempts meritless shareholder "strike suits" alleging violations of state law so as to avoid the stringent pleading requirements imposed by the PSLRA. Its application here is an attempt to fit a square peg in a round hole. The Trustee's action is not a shareholder strike suit nor does it assert causes of action based on state law to avoid the strict pleading requirements of the federal securities laws. To the contrary, the Trustee's action is replete with just the type of detailed allegations of JPMC's misconduct which would be required by the PSLRA were these securities fraud claims brought by a plaintiff class. Even failing to recognize these critical distinctions, the Trustee's efforts are protected—as are the efforts of all bankruptcy trustees—by the entity exception written into the statute itself. Like a typical bankruptcy trustee, a SIPA trustee and the estates he represents are protected by the entity exception, which counts certain entities as one person for purposes of SLUSA preemption. The only distinction between this Trustee and a typical bankruptcy trustee is that, by statute, a SIPA trustee seeks recovery for the benefit of a dual estate that comprises both preferred creditors (*i.e.*, "customers") and general creditors. This distinction has no effect on the application of the entity exception.

Regardless of the number of individuals who will receive distributions from the fund of customer property, SLUSA does not preempt the efforts of an entity when, as in the instant case, that entity was not established for the purpose of bringing the challenged litigation. Because neither the Trustee nor the estates he represents were "established for the purpose of litigation," his efforts are not subject to SLUSA preemption.

A. The Policies and Objectives Behind SLUSA Are Not Implicated by the Trustee's Litigation Against JPMC in Bankruptcy Court

SLUSA was enacted to close a loophole in the PSLRA. Thus, "to understand SLUSA, one must first understand the PSLRA." *LaSala v. Bordier et Cie*, 519 F.3d 121, 128 (3d Cir. 2008). The PSLRA was Congress's response to the ways in which the class-action device was "being used to injure 'the entire U.S. economy' . . . [through] nuisance filings, [the] targeting of deep-pocket defendants, vexatious discovery requests, and [the] 'manipulation by class action lawyers of the clients whom they purportedly represent.'" *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (internal citations omitted). Among other things, the PSLRA limited attorneys' fees, set forth a more restrictive process for the selection of lead plaintiffs, and heightened the pleading requirements to allege securities fraud, demanding that plaintiffs allege, with specificity, the misleading statements forming the basis of a fraud claim and facts "giving rise to a strong inference" of scienter. *Id*. at 82.

The PSLRA had an "unintended consequence: it prompted at least some members of the plaintiffs' bar to avoid the federal forum altogether. Rather than face the obstacles set in their path by the [PSLRA], plaintiffs and their representatives began bringing class actions under state law, often in state court." *Id.* Congress enacted SLUSA "[t]o stem this 'shif[t] from Federal to state courts' and 'prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA].'" *Id*. (quoting Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 §§ 2(2), (5), 112 Stat. 3227, 3227 (1998)); *see also Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d Cir. 2001).

SLUSA preempts: (i) a covered class action; (ii) based on state law; (iii) alleging untrue statements or omissions of material fact; (iv) in connection with the purchase or sale of; (v) a covered security. 15 U.S.C. § 77p(b). In relevant part, a "covered class action" is a lawsuit in which: "(I) damages are sought on behalf of more than 50 persons or prospective class members . . . or . . . (II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated . . . ." 15 U.S.C. § 77p(f)(2)(A)(i). Significantly, SLUSA contains an entity exception which provides that: "a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action." 15 U.S.C. § 77p(f)(2)(C). As Congress explained, SLUSA was drafted to ensure that the efforts of bankruptcy trustees (or those otherwise "duly authorized by law" "to seek damages on behalf of another entity") would not be preempted:

> The class action definition has been changed from the original text . . . to ensure that *the legislation does not cover instances in which a person or entity is duly*

> *authorized by law*, other than a provision of state or federal law governing class action procedures, *to seek damages on behalf of another person or entity*. Thus, a *trustee in bankruptcy*, a guardian, a receiver, and other persons or entities duly authorized by law (other than by a provision of state or federal law governing class action procedures) to seek damages on behalf of another person or entity *would not be covered by this provision*.

S. Rep. No. 105-182 at 6 (1998) (emphasis added).

Thus, the Trustee's action does not implicate the concerns addressed by SLUSA and, as Congress made explicitly clear, was never meant to fall within the class of cases SLUSA was designed to preempt. This case is not—and does not in any way resemble—the meritless shareholder "strike suits" which prompted the enactment of SLUSA. *See Adelphia Commc'ns. Corp. v. Bank of Am. N.A.* (*In re Adelphia Commc'ns Corp.*), No. 03-04942 (REG), 2007 WL 2403553, at *3 (Bankr. S.D.N.Y. Aug. 17, 2007) (rejecting use of SLUSA to preempt litigation because the Court saw "no nexus between this lawsuit and the ills intended to be addressed by SLUSA, and does not believe that the asserted construction of SLUSA furthers the Congressional intent in enacting this legislation."). Similarly, the Trustee does not here seek to avoid the heightened pleading requirements of federal securities laws through an action based in state law. The Trustee is not a "class representative seeking recovery on his own behalf" or for others similarly situated. Rather, the Trustee is pursuing claims authorized by SIPA and the Bankruptcy Code on behalf of the BLMIS estate, a judgment creditor, and/or the fund of customer property. This case is not subject to SLUSA preemption.

B. The Rules of Statutory Construction Support the Trustee's Position That SLUSA Does Not Bar the Trustee's Claims

JPMC claims that "SLUSA bars the Trustee's aggregation and assertion in a single action of state law claims belonging to Madoff's customers, *even if the Trustee has standing to assert such claims*." (Def. Br. 23) (emphasis added). Were this Court to accept JPMC's claim, it would be holding that SLUSA impliedly repealed powers granted to the Trustee under SIPA and the Bankruptcy Code. This cannot be correct.

SIPA was enacted in 1970 as an amendment to the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78bbb. The Bankruptcy Code was enacted in 1978. *See Kelly v. Robinson*, 479 U.S. 36, 44 (1986). As described above, multiple provisions in these statutes provide the Trustee with standing to bring his common law claims against JPMC. SLUSA was enacted in 1998—after both SIPA and the Bankruptcy Code—as an amendment to the Securities Act of 1933 and the 1934 Act. *See Dabit*, 547 U.S. at 82 n.6. To accept JPMC's argument is to hold that SLUSA impliedly repeals portions of SIPA and the Bankruptcy Code. Neither the express language of SLUSA nor its legislative history suggest Congress intended this result. In the absence of an expressed intent to the contrary, subsequent legislation is not presumed to repeal existing law. *Frost v. Wenie*, 157 U.S. 46, 57–58 (1895). Thus, JPMC's reading of SLUSA must be rejected.

C. This Case Is Not a Covered Class Action

1. The Trustee and the Estates He Represents Have "Entity Status"

In accord with the statute's purpose, courts have acknowledged that SLUSA was never meant to preclude lawsuits by a bankruptcy trustee or the entities he represents. *See, e.g.*, *Lee v. Marsh & McLennan Cos., Inc.*, No. 06 Civ. 6523 (SWK), 2007 WL 704033, at *4 (S.D.N.Y. Mar. 7, 2007) ("[A] typical Chapter 11 trust established to represent a bankrupt estate for all purposes, including the litigation of outstanding causes of action, is entitled to entity treatment."); *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1007–08 (9th Cir. 2005) (holding that a bankruptcy trustee satisfied the entity exception under SLUSA because trustee had other responsibilities beyond the lawsuit at issue, and where a contrary finding under SLUSA "could potentially deprive many bankruptcy trusts of the ability to pursue state-law securities fraud claims on behalf of an estate").

In this Court's Order withdrawing the reference, the Court stated that *Smith* is distinguishable because the trustee there stood in the shoes of the debtor. *Picard v. JPMorgan Chase & Co.* (*In re Bernard L. Madoff*), No. 11 Civ. 0913 (LM), 2011 WL 2119720, at *5 (S.D.N.Y. May 23, 2011). But every bankruptcy trustee ultimately seeks recovery for creditors of the debtor no matter what the trustee's basis for standing.

The entity exception codifies Congress's intent to exclude from SLUSA's reach actions in which bankruptcy trustees are seeking recovery on behalf of the estate, even though that recovery may benefit thousands of creditors. Indeed, just as pension plans and shareholder derivative actions are exempt from SLUSA even though they benefit numerous individuals, so, too, is it irrelevant who benefits here. As JPMC's own authority acknowledges, the fact that numerous people will benefit from the Trustee's claims is not relevant to SLUSA preclusion. *See Bordier*, 519 F.3d at 133–34.

2. Neither the Trustee Nor the Estates He Represents Were Established for the Purpose of Bringing This Litigation

The application of the entity exception here is clear by the single fact that the Trustee was not "established" for the purpose of bringing this litigation. The language of SLUSA is unambiguous: a lawsuit brought by an entity which was "not established for the purpose of participating in the action" is not a "covered class action," and is, correspondingly, not preempted by SLUSA. 15 U.S.C. § 77p(f)(2)(C).

This threshold inquiry is dispositive of JPMC's argument: because neither the Trustee nor the estates he represents were established for the purpose of bringing this litigation, the Trustee's efforts are protected by the entity exception, and no further analysis is required. *See Marsh & McLennan*, 2007 WL 704033, at *4.

As explained by Judge Haight in *LaSala v. Bank of Cyprus Public Company Ltd.*:

> Thus, if damages are sought on behalf of an entity (perhaps in addition to other persons), and the entity itself benefits multiple persons, that entity will nonetheless be treated as one person if it was not established for the purpose of participating in the action. *In other words, the beneficiaries of damages that would accrue to an entity will only be counted towards the 50-person limit under circumstances where the entity was established to participate in the action.*

510 F. Supp. 2d 246, 268 (S.D.N.Y. 2007) (emphasis added); *see also LaSala v. UBS*, 510 F. Supp. 2d 213, 234 (S.D.N.Y. 2007). Neither the Trustee nor the estates he represents were established for the primary purpose of bringing this litigation.

The Trustee was appointed on December 15, 2008 by Judge Stanton. As required by SIPA, Judge Stanton's order appointed the Trustee for the purpose of liquidating the estate of BLMIS, and then removed that liquidation proceeding to the Bankruptcy Court. *See* Order, *SEC v. Bernard L. Madoff*, No. 08-10791 (LLS) (Dec. 15, 2008), Dkt. No. 4. Judge Stanton did not appoint the Trustee in order to bring this action. At the time he was appointed, the Trustee was a stranger to the facts, circumstances, and evidence connected to the Ponzi scheme. He was not yet aware of JPMC's connection to Madoff or of JPMC's substantial assistance to Madoff thus furthering the Ponzi scheme, as alleged in the Amended Complaint. Thus, the Trustee was not—and could not—have been established for the primary purpose of bringing this litigation (or, indeed, any other adversarial proceeding brought to recover funds for BLMIS).

The Trustee's responsibilities are far broader. He was appointed to oversee all aspects of the consolidated liquidation of BLMIS, which include, among other things, marshaling and selling certain assets of BLMIS, determining over 16,000 customer claims, creating processes and procedures for the orderly administration of the estates, allocating customer property among the customers of BLMIS, and bringing litigation where necessary to recover monies to be equitably distributed, *pro rata*, through the fund of customer property to customers with allowed claims. *See* Order on Application for an Entry of an Order Approving Form and Manner of

Publication and Mailing of Notices, Specifying Procedures for Filing, Determination, and Adjudication of Claims; and Providing Other Relief, *SIPC v. Bernard L. Madoff Inv. Sec. LLC*, No. 08-01789-BRL (Dec. 23, 2008), Dkt. No. 12 ("Trustee Procedures Order"). That neither the Trustee nor the estates he represents were established for the primary purpose of suing JPMC should end the inquiry into SLUSA preemption. *UBS*, 510 F. Supp. 2d at 234.

This action is distinct from the case cited by JPMC, *Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4, 10 (D. Mass. 2003). (Def. Br. 28–29.) In *Cape Ann*, the prosecuting trust was not protected by the entity exception because it was specifically created for the primary purpose of bringing the challenged litigation. *Cape Ann*, 296 F. Supp. 2d at 9–12. Further, the trustee in that case brought state-law based fraud claims to circumvent federal securities law; this is the precise conduct against which SLUSA was directed. *Id.* at 10–12; *see also RGH*, 71 A.D.3d at 205.

D. The Common Law Claims Are Not Brought "On Behalf of" Individual Customers

SLUSA also does not apply because the common law claims are brought by the Trustee under theories of standing that do not implicate SLUSA. For his contribution claim, the Trustee stands in the shoes of BLMIS, just like the bankruptcy trustee in *Smith*. With regard to the remaining common law claims, the Trustee acts as a hypothetical judgment creditor, a bailee of customer property, and enforcer of SIPC's subrogation rights. While the Trustee has alleged that he could have standing pursuant to assignments from customers, he has no such assignments to date. If he did, on JPMC's theory he could easily assert 50 or fewer assignments if SLUSA were deemed to be at all relevant. But limiting his ability to achieve his statutory obligations in this manner points to the absurdity of applying SLUSA in this context at all.

Significantly, the two main cases discussed by JPMC are not bankruptcy trustee cases at all, but cases dealing with assignments made to trusts. And, even in those cases, SLUSA was not held to preclude claims in those suits. In *RGH Liquidating Trust v. Deloitte & Touche LLP*, No. 0000961/2007, 2011 WL 2471542 (N.Y. June 23, 2011), the New York Court of Appeals addressed an action brought by a trust. Groups of unsecured general creditors had assigned claims to the trust, which included claims against the debtor's accountant and actuary. The defendants argued that the trust's claims were preempted by SLUSA because they were being brought on behalf of more than 50 unsecured creditors. Importantly, the New York Court of Appeals held that the entity exception applied to the trustee's claims and protected the action from SLUSA preemption. The court explained that "[b]y adding a single-entity exemption in the final bill to cover legal entities that may act on behalf of numerous beneficiaries, Congress made sure that, in bringing suits in their own names, these entities would be counted as one person." JPMC's only rebuttal to this case is that the majority made the wrong decision.

In *Bordier*, the Third Circuit held that SLUSA would not preclude the prosecution of state law aiding and abetting breach of fiduciary duty claims which had passed from a corporation to a bankruptcy estate to a trust. 519 F.3d at 137. The trust at issue was a hybrid between a litigation trust and a liquidating trust, and its purpose was not only to litigate, but to distribute assets. *Id*. at 127 n.1. The district court had ruled that the single entity exception under § 78bb(f)(5)(D) would not apply because the trust was established for the primary purpose of litigation. *Id*. at 133. Accordingly, for this reason, the Third Circuit "looked through" the trust to determine its constituents, acknowledging that unless an entity were "established for the purpose of bringing the action, *i.e.*, to circumvent SLUSA," "the court is to follow the usual rule of not looking through an entity to its constituents." *Id*. at 133–34. Looking through the entity, the *Bordier* court decided to look at the original owners of the claims at issue precisely because the case involved assignments to a trust and the lower court had found that the trust was established primarily to pursue ligation. Unlike this case, *Bordier* did not involve claims by a bankruptcy estate trustee acting in his fiduciary capacity and who clearly was not "established" for the primary purpose of litigation. Not only does *Bordier* not stand for the proposition that looking through an entity is appropriate under the circumstances here, it also does not stand for the proposition that when "looking through" a *bankruptcy estate*, one should count the creditors whose claims are being asserted by the only party with standing to assert those claims—the trustee.

E. The Trustee Has Not Alleged That JPMC Committed Securities Fraud

Because the claims against JPMC are not based on untrue statements or omissions in connection with the purchase or sale of covered securities, there is no SLUSA preemption. And JPMC's tortious conduct, as described in the Amended Complaint, is not "in connection with" securities fraud, but is related to its banking responsibilities to monitor its client's irregular activities and duty not to help foster Madoff's Ponzi scheme. For this reason as well, the Trustee's common law claims do not fall within the range of actions preempted by SLUSA.

1. No Securities Were Purchased or Sold

Since the securities did not exist, SLUSA does not apply. In *In re J.P. Jeanneret Associates, Inc.*, this Court stated that for purposes of Rule 10(b), "[t]he Court has not found any Supreme Court or Second Circuit jurisprudence that directly addresses whether phony purchases or sales of securities can be relied on to satisfy the 'in connection with' requirement." 69 F. Supp. 2d 340, 363 (S.D.N.Y. 2011) (McMahon, J.). Lacking such guidance from a higher court, this Court held in that case that "it seems likely that the requirement can be satisfied in circumstances like those at bar—where the plaintiffs part with money intending that it be invested in securities, only to have the person to whom that money is entrusted steal it." *Id.*

Here, however, the Second Circuit has ruled that Madoff's purported trades can have *no legal effect*. In *In re BLMIS*, the Second Circuit, in a decision written by Chief Judge Jacobs, ruled:

> The statutory definition of "net equity" does not require the Trustee to aggravate the injuries caused by Madoff's fraud. Use of the Last Statement Method in this case would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations.

2011 WL 3568936, at *5; *see also id.* at *11 ("assessing 'net equity' based on . . . customer statements would require the Trustee to establish each claimant's 'net equity' based on a fiction created by the perpetrator of the fraud"). The Second Circuit's decision indicates that the fiction maintained by a fraudster, or an investor's expectations based on that fiction, should not be determinative of legal rights. Nor should this Court allow a fiction to determine legal rights. There were no securities sold or purchased here, and therefore this case falls outside of SLUSA.

2. Even If There Had Been Securities, Madoff's Fraud Is Too Remote for SLUSA to Apply

Even if the securities had been real, the securities fraud committed by Madoff does not mandate the application of SLUSA in any event. Courts of this Circuit have previously addressed this very issue. In *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d. 372 (S.D.N.Y. 2010), a group of investors in various BLMIS feeder funds brought securities fraud claims, including claims for breaches of fiduciary duties, against those funds and certain service providers. *Id.* at 404–21, 423–42. The court held that because the relevant securities fraud was committed by Madoff, not by the feeder funds, the complaint did not allege tortious conduct "in connection with" securities fraud, so as to be preempted by SLUSA. *Id.* at 398.

Similarly, in this case, the Trustee has alleged that JPMC's conduct aided and abetted Madoff's fraud, breach of fiduciary duty and conversion, that JPMC knowingly participated in that fraud, that JPMC converted customer property, that JPMC was unjustly enriched, and that it must contribute as a joint tortfeasor. As the district court explained in *Anwar*, these types of claims cannot be preempted by SLUSA because JPMC's participation in the fraud was only tangentially related to securities, if they existed at all:

> Though the Court must broadly construe SLUSA's "in connection with" phrasing, stretching SLUSA to cover this chain of investment—from Plaintiffs' initial investment in the Funds, the Funds' reinvestment with Madoff, Madoff's supposed purchases of covered securities, to Madoff's sale of those securities and purchases of Treasury bills—snaps even the most flexible rubber band.

Id. at 399; *see also Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 750 F. Supp. 2d 450, 453–56 (S.D.N.Y. 2010) (investment in hedge funds, even when those funds indisputably invest in covered securities, did not implicate SLUSA); *UBS*, 510 F. Supp. 2d at 240 ("If merely making allegations of fraud somewhere in the complaint were sufficient to bring the case within the reach of SLUSA, a class action complaint for commission of an environmental tort, that also alleged that the company fraudulently altered its books and thereby deceived shareholders, would be preempted, even if the claim against the defendant had nothing to do with securities fraud.").[11]

[11] Nor is the Second Circuit's decision in *MLSMK Investment Co. v. JPMorgan Chase & Co.*, No. 10-3040-CV, 2011 WL 2640579 (2d Cir. July 7, 2011), apposite. In *MLSMK*, the Second Circuit held only that allegations of predicate acts of securities fraud are sufficient to bar a RICO action under the PSLRA. When the plaintiff then tried to run from his own allegations by contending that the defendant itself did not engage in securities fraud, the Second Circuit stated, in *dicta*, that allegations amounting to aiding and abetting securities fraud are sufficient to fall under Rule 10(b) and preclude a RICO claim.

VI. THE TRUSTEE HAS SUFFICIENTLY ALLEGED EACH AND EVERY CLAIM IN THE COMPLAINT

A. Standard of Review

On JPMC's motion to dismiss, the Court "must liberally construe all claims, accept all factual allegations in the [Amended C]omplaint as true, and draw all reasonable inferences" in favor of the Trustee. *J.P. Jeanneret Assoc.*, 769 F. Supp. 2d at 353 (citing *Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41, 44 (2d Cir. 2003)). The Court may consider the full text of the documents the Trustee refers to in the Amended Complaint. *Id.* at 354 (citing *Rothman v. Gregor*, 220 F.3d 81, 88–89 (2d Cir. 2000)).

A complaint is generally required only to include "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2). A complaint must state a plausible claim for relief, but does not have to establish liability. *See Iqbal*, 129 S. Ct. at 1949. In determining plausibility, a "[c]ourt must draw on its judicial experience and common sense to decide whether the factual allegations raise a right to relief above the speculative level." *Merkin*, 440 B.R. at 254 (internal marks and citation omitted). While allegations of fraud are held to the higher pleading standard of Rule 9(b), "[g]reater liberality in the pleading of fraud is particularly appropriate in bankruptcy cases, because . . . it is often the trustee, a third party outsider to the fraudulent transaction, that must plead the fraud on secondhand knowledge for the benefit of the estate and all of its creditors." *See, e.g.*, *Merkin*, 440 B.R. at 254 (quoting *SIPC v. Stratton Oakmont, Inc.*, 234 B.R. 293, 310 (Bankr. S.D.N.Y. 1999) (internal marks and citation omitted)). In addition, Rule 9(b) permits "[m]alice, intent, knowledge, and other conditions of a person's mind" to be pled generally. Fed. R. Civ. P. 9(b).

Courts also give trustees leeway in pleading on information and belief, "[s]ince a bankruptcy trustee rarely has personal knowledge of the events preceding his appointment, . . .

provided that he pleads specific facts supporting an inference of knowledgeable participation in the alleged fraud." *Official Comm. of Unsecured Creditors of Grumman Olson Indus. Inc. v. McConnell* (*In re Grumman Olson Indus., Inc.*), 329 B.R. 411, 429 (Bankr. S.D.N.Y. 2005) (internal marks and citation omitted); *Boykin v. KeyCorp.*, 521 F.3d 202, 215 (2d Cir. 2008).

Finally, neither JPMC's attempts to introduce facts not pled in the Amended Complaint nor to rewrite the Trustee's factual allegations are proper. *See Friedl v. City of New York*, 210 F.3d 79, 83–84 (2d Cir. 2000); *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 332–33 (S.D.N.Y. 2003).

B. The Trustee's Allegations Regarding JPMC's Knowledge of and Participation in Madoff's Fraud

The entirety of Madoff's fraudulent scheme was laid out before JPMC. JPMC participated in every single aspect of the Ponzi scheme: it housed the funds, it performed the transfers, it collected fees and interest, it lent money to BLMIS, it lent money to individuals to give to BLMIS, and it watched billions of dollars flow back and forth between BLMIS's main account at JPMC (the "703 Account") and various customers and feeder funds—including one of JPMC's most important customers, Norman Levy—in patterns that can be explained only by fraud. (Am. Compl. ¶¶ 2–4, 252–54, 273–95.) JPMC knew that Madoff claimed to be using the 703 Account to buy and sell securities for customers of BLMIS. But nothing in the flow of cash that JPMC saw every day was remotely consistent with the purchase or sale of securities. (*Id.* ¶¶ 192, 243–44.) Instead, it was consistent with check fraud, money laundering, or other evidently criminal activity of the sort that JPMC is required to identify, report, and stop, under federal and state law, agreements with state and federal agencies, and its own internal policies. (*Id.* ¶¶ 192–96, 206, 208, 210–11.)

For decades, the 703 Account showed textbook signs of fraud: unusual repetitive transactions, distinctive patterns of large dollar transactions, spikes and dramatic decreases in overall activity, wire activity with offshore entities, and negotiation of multimillion dollar checks and transactions that could have created no legitimate financial value for either party. (*Id.* ¶¶249(a)–(e).) Taken together and repeated daily over a period of years, they lead to the inescapable conclusion of fraud. JPMC knew that the 703 account was not used for the purchase or sale of securities. (*Id.* ¶ 190.) It saw the lack of segregated customer accounts and that Norman Levy, friend of JPMC's chairman of the board, one of its most important customers, and one of the largest real estate magnates in New York, was depositing millions of dollars into the 703 account and simultaneously withdrawing equivalent amounts, almost on a daily basis. (*Id.* ¶¶ 192, 252.) JPMC further saw that Sterling Equities was depositing handwritten checks for millions of dollars through teller transactions. (*Id.* ¶ 258.)

JPMC appears to find consolation in the fact that JPMC is not alleged to have "ever, disabled, compromised, or ignored its [fraud] detection system for Madoff's benefit." (Def. Br. 39.) The Trustee has no knowledge as to the mechanics by which JPMC allowed Madoff's fraud to continue, and it makes no difference for these purposes whether the fraud alert system was deliberately turned off, whether it issued alerts that were ignored, or whether it was simply ineffective. JPMC's knowledge is not limited to whatever the fraud detection system happened to pick up. It knew the contents of its own books and records, the records that it created and relied on in performing its business. The Trustee's allegations about what JPMC "'should' have done" as to the 703 Account and what a review of Madoff's accounts "would have revealed" (*see* Def. Br. 38,) are based on what JPMC *actually knew* from its own transaction records.

JPMC also knew that Madoff lied to the SEC about the bank's loans to BLMIS, as well as BLMIS's revenue. (Am. Compl. ¶¶ 216–39.) JPMC received and reviewed BLMIS's FOCUS reports and Annual Audited reports. (*Id.*) These reports dramatically misstated BLMIS's cash on hand; showed no evidence of existing customer accounts at BLMIS; erroneously reported BLMIS's outstanding bank loan obligations; and failed to report commission revenue—all falsehoods that JPMC knew to be incorrect based on its role as BLMIS's banker and lender, and as an investor in BLMIS feeder funds. (*Id.*) Again, JPMC's protest that "there is no allegation that anyone at JPMorgan *noticed* or drew negative inferences from" the false statements is unavailing. (*See* Def. Br. 39 n.8) (emphasis added.) Having received and reviewed those reports, as alleged in the Amended Complaint, JPMC is charged with actual knowledge of what they contained.

Finally, JPMC decided to offer structured finance products based on BLMIS feeder funds and purported to conduct due diligence on those funds in 2006, 2007, and 2008. (Am. Compl. ¶¶ 91–151.) JPMC twists the Trustee's allegations: "the Trustee makes no effort to explain why JPMorgan would conduct multiple rounds of due diligence relating to Madoff if the bank already knew he was operating a Ponzi scheme." (Def. Br. 41.) But the Trustee has not alleged that JPMC conducted proper due diligence. He alleges that as soon as JPMC began going through the motions of its ordinary due diligence procedures, it bumped up against *more* evidence of fraud, including:

- BLMIS's returns "were 'too good to be true' and could not be reconciled with market conditions;"
- BLMIS's operations lacked transparency;
- Madoff's auditor was unregistered, not subject to peer review, and had no website;
- Madoff disfavored banks structuring products on his strategy and did not want anyone performing due diligence on BLMIS;

- Madoff would not tell the BLMIS feeder funds the names of the counterparties to the options transactions he was supposedly entering into on their behalf;
- Madoff's returns were speculated to be part of a Ponzi scheme;
- The trades Madoff supposedly made were not independently verified;
- Madoff's family members had critical roles at BLMIS;
- There were striking similarities between BLMIS's operations and the Refco and Petters frauds;
- The BLMIS feeder funds gave JPMC inconsistent answers in response to the bank's questions about Madoff and BLMIS;
- Sonja Kohn, the founder and majority shareholder of Bank Medici and longtime friend of Madoff, was unable to "provide credible responses to a number of questions related to the managed accounts Bank Medici had with BLMIS;"
- Fairfield Greenwich Group knew very little about how BLMIS operated and was extremely reluctant to push Madoff for answers; and
- "[T]here was a substantial risk that Madoff and/or BLMIS was a fraud."

(Am. Compl. ¶¶ 6, 8–9, 96, 105, 127, 133, 141, 145, 149, 501.) Notably, despite the failure of BLMIS to pass any level of due diligence, JPMC nonetheless decided to offer structured products, thus demonstrating the irrelevance of the exercise to its decision-making. (*Id.* ¶¶ 116–24.)

JPMC knew Madoff was a fraud, and finally reported it to a government authority in October 2008. JPMC filed a report of suspicious activity with the United Kingdom's Serious Organised Crime Agency ("SOCA") in October 2008, which was publicly reported by the French press long before the Trustee filed his Complaint. (*Id.* ¶¶ 11–12, 155.) The SAR corroborates what the Trustee alleges elsewhere: that JPMC knew that BLMIS appeared "too good to be true:"

> (1) the *investment performance* achieved by [BLMIS's] funds which is so *consistently and significantly ahead of its peers*, year-on-year, even in the prevailing market conditions, as to appear *too good to be true*—meaning that it

> probably is; and (2) the *lack of transparency* around Madoff Securities' trading techniques, *the implementation of its investment strategy*, and the *identity of its OTC option counterparties*; and (3) its unwillingness to provide helpful information. *As a result, JPMC[] has sent out redemption notices in respect of one fund, and is preparing similar notices for two more funds.*

(*Id.* ¶ 155.) (Emphasis in original.) Similarly, JPMC argues that its "Lessons Learned" document circulated shortly after Madoff's exposure, "never suggests that anyone at JPMorgan knew all along that BMIS was a criminal enterprise." (Def. Br. 44.) Indeed, this document points to JPMC's decision to ignore indicia of fraud. The Trustee also alleges that several JPMC employees admitted that they were "not surprised" to hear Madoff was operating a fraud. (Am. Compl. ¶ 165.)

More than merely observing Madoff's fraud, JPMC participated in it. Another financial institution, when faced with circular transactions similar to those between Levy and the 703 account, confronted BLMIS employees and closed the account. (*Id.* ¶ 211.) JPMC instead lent Levy hundreds of millions of dollars specifically for use in those transactions, then extended BLMIS itself almost $150 million in credit. (*Id.* ¶¶ 273–95.) JPMC contends that it would not have participated in a fraud for "routine banking fees." (Def. Br. 32.) Yet, as evidenced by its conduct in the Enron fraud, JPMC will participate in fraud in order to accommodate important customers. (Am. Compl.¶¶ 8, 181–89.) Here, JPMC accommodated a web of important banking relationships, including Madoff, Levy, Shapiro and Sterling Equities. (*See id.* ¶¶ 198, 250, 273.) Moreover, as its own internal documents show, for JPMC, fraud mattered only if it affected its bottom line, so all it did was a cost-benefit analysis, taking into account the likelihood for fraud, when issuing products structured on BLMIS feeder funds. (*Id.* ¶ 7.)

JPMC also knew that the 703 Account was a fiduciary account, containing BLMIS "customer money." (*Id*. ¶ 200.) As alleged, JPMC knew that Madoff and/or BLMIS had a fiduciary relationship with BLMIS customers:

- JPMC knew BLMIS and Madoff had discretionary control over customer accounts;
- JPMC knew BLMIS and Madoff acted as investment advisers and used the 703 Account to serve the IA business; and
- It was a matter of public record that Madoff, in his capacity as an investment adviser, acted as trustee for a number of retirement accounts, pension plans and trusts.

The document JPMC introduces to attack these allegations does not show anything different. (*See* Def. Decl. Ex. 7.) The document indicates only that Madoff opened a business account at JPMC; it does not provide any other information regarding the nature of the account, much less whether the account was to be used to serve a fiduciary relationship. In any event, the allegations of JPMC's knowledge of the fiduciary nature of the relationship are overwhelming, and cannot be disregarded on a motion to dismiss.

JPMC argues that the Trustee has included allegations about JPMC's participation in other high profile misdeeds "including the Enron fraud, but without drawing any specific connection between those alleged misdeeds and the Madoff fraud." (Def. Br. 40.) One specific connection alleged in the Amended Complaint is that after its participation in the Enron fraud, JPMC submitted to a remedial order with state and federal regulators, pursuant to which it was required to draft and implement procedures to improve its compliance, precisely to prevent what happened here. (Am. Compl. ¶¶ 181–89.) Yet all the time that JPMC was negotiating with regulators, drafting the remedial policies, ostensibly implementing them, reassuring its shareholders of its improved procedures, reporting to regulators on its progress from the order, and ultimately being released from the order (presumably for successful compliance), JPMC was knowingly facilitating the largest Ponzi scheme in history. JPMC should be held liable for its misconduct.

C. The Trustee Has Sufficiently Alleged that JPMC Knowingly Participated in Madoff's Breach of Trust

The Trustee has alleged that JPMC knowingly participated in Madoff's breach of trust to BLMIS's customers and is, therefore, liable for the entire amount Madoff misappropriated through the 703 Account. (Am. Compl. ¶¶ 490–506.) JPMC contends that the claim does not exist separate and apart from a claim for breach of fiduciary duty and, even if it did, the Trustee has not adequately pled its elements. (Def. Br. 33, 45–49.) JPMC's argument ignores a century of decisions recognizing the claim under New York law, as well as the substantial body of facts underlying the Trustee's claim. Moreover, JPMC essentially admits that the issue of Madoff and/or BLMIS's fiduciary relationship with BLMIS customers is a question of fact, and, as such, it is not appropriate for dismissal. (*Id.* at 48.)

1. Knowing Participation in a Breach of Trust Is a Cognizable Claim Under New York Law

The concept that banks can be held liable for participating in a breach of trust has long been embodied in trust law and has been adopted by New York courts and the Second Circuit. *See* Restatement (Second) of Trusts § 324 (1959); *accord* George G. Bogert, George T. Bogert, & Amy M. Hess, Bogert's Trusts & Trustees § 901 (2010). While, "[a]s a general matter, [b]anks do not owe non-customers a duty to protect them from the intentional torts of their customers," there is an exception to this rule. *See Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 286 (2d Cir. 2006). As articulated in the Restatement:

> If the trustee deposits trust funds in a bank, the bank is liable for participating in the breach of trust in receiving or in permitting the trustee to withdraw the trust funds, where the trustee commits a breach of trust in making the deposit or withdrawal, if, but only if, the bank received the deposit or permitted the withdrawal with notice of the breach of trust.

Restatement (Second) of Trusts § 324 (1959); *see Lerner*, 459 F.3d at 287–90.

New York recognized "knowing participation" as a viable cause of action almost a century ago, and courts have affirmed its viability as recently as last year. *See e.g.*, *Chaney v. Dreyfus Serv. Corp.*, 595 F.3d 219, 232–35 (5th Cir. 2010) (applying New York law); *Lerner*, 459 F.3d at 287–90; *D.M. Rothman & Co., Inc. v. Korea Comm. Bank of N.Y.*, 411 F.3d 90, 99 (2d Cir. 2005); *Bischoff v. Yorkville Bank*, 218 N.Y. 106, 112 (1916); *Home Sav. of Am., FSB v. Amoros*, 233 A.D.2d 35, 38–40 (1st Dep't 1997).

In *Bischoff*, the New York Court of Appeals explained the theory behind the cause of action:

> [A] banker who knows that a fund on deposit with him is a trust fund cannot appropriate that fund for his private benefit, or where charged with notice of the conversion join in assisting others to appropriate it for their private benefit, without being liable to refund the money if the appropriation is a breach of the trust.

Bischoff, 218 N.Y. at 112 (quoting *Allen v. Puritan Trust Co.*, 97 N.E. 916, 919 (Mass. 1912)).

The Second Circuit in *Lerner* relied on *Bischoff* in refusing to dismiss a claim that a bank knowingly participated in a breach of trust by its customers. *Lerner*, 459 F.3d at 287–90. In *Lerner*, the plaintiffs were investors in a Ponzi scheme perpetrated by David Schick. *Id.* at 278. Schick directed his customers to deposit their investment funds in accounts at three defendant banks. *Id.* at 279. Schick told his customers that he would use the funds to invest in "a no-risk scheme for generating a high return on their investments." *Id.* at 279. Instead, Schick stole their money. The customers argued that the banks were on notice that Schick was breaching his fiduciary duty because the accounts were frequently overdrawn. *See id.* at 278–90. The court vacated the district court's dismissal of the claim, explaining, "[b]y ignoring evidence of Schick's misconduct and allowing him to continue to use Republic accounts, Republic allegedly allowed itself to become a conduit for Schick's activities." *Id.* at 290.

2. The Trustee Has Pled Facts Sufficient to State a Claim that JPMC Knowingly Participated in BLMIS's and Madoff's Breach of Trust

To state a claim for knowing participation, the Trustee must allege: (1) a fiduciary relationship between the bank's customer and a third party; (2) the bank knew or should have known of the fiduciary relationship; and (3) the bank had actual knowledge or notice that the bank's customer was misappropriating funds. *See, e.g.*, *Chaney*, 595 F.3d at 232 (citing *Amoros*, 233 A.D.2d at 38). Notice of the diversion triggers a duty whereby the bank must "'make reasonable inquiry and endeavor to prevent a diversion.'" *Lerner*, 459 F.3d at 287–88 (quoting *Bischoff*, 218 N.Y. at 114).

Rather than addressing the Trustee's claim on its merits, JPMC attempts to persuade the Court that it should dismiss the claim as "duplicative" of the Trustee's aiding and abetting breach of fiduciary duty claim. (Def. Br. 33.) This is contrary to controlling precedent in this Circuit and is not supported by JPMC's cases. As the Second Circuit has repeatedly explained, these are distinct claims with distinct elements. *See* Lerner, 459 F.3d at 287–90, 294–95 (analyzing a knowing participation claim under a negligence standard and then separately analyzing the aiding and abetting breach of fiduciary duty claim); *accord MLSMK Inv. Co.*, 2011 WL 2176152, at *3; *In re Agape Litig.*, 681 F. Supp. 2d 352, 359–61 (E.D.N.Y. 2010); *Renner v. Chase Manhattan Bank*, No. 98 Civ. 926, 1999 WL 47239, at *13–14 (S.D.N.Y. 1999).

The cases cited by JPMC are inapposite because they involved claims that were akin to aiding and abetting breach of fiduciary duty claims and the courts analyzed them accordingly. *See Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 46 (2d Cir. 2005) (lender assisted the debtor's controlling shareholders in looting the company); *S & K Sales Co. v. Nike, Inc.*, 816 F.2d 843, 847–48 (2d Cir. 1987) (shoe manufacturer agreed to be represented by plaintiff's employer individually after his employer indicated it would not represent the manufacturer); *Whitney v. Citibank, N.A.*, 782 F.2d 1106, 1115–19 (2d Cir. 1986) (bank entered into contract with partners for the sale of property, which breached their fiduciary duties to the partnership). In addition, *Whitney* states only that the claim is analogous to an aiding and abetting securities claim—not that the claims are "duplicative." 782 F.2d at 1115. Notably the *Lerner* and *MLSMK* courts did not cite any of the cases cited here by JPMC in their discussions of knowing participation.

And Rule 8(d)(2) makes clear, in any event, that at the pleading stage, plaintiff has the right to plead alternative theories sustaining his claims and that "the pleading is sufficient if any one of them is sufficient."

a. There was a Fiduciary Relationship Between Madoff and/or BLMIS and the IA Business Customers

As the Trustee alleges, BLMIS and Madoff owed a fiduciary duty to IA Business customers and Madoff breached that duty when he misappropriated customers' investment funds. (Am. Compl. ¶¶ 200, 491.) JPMC does not deny that a fiduciary relationship existed between Madoff and BLMIS and the customers of the IA Business. Instead, JPMC contorts the case law to suggest that the 703 Account itself had to be specifically labeled as a "fiduciary account" in order for a knowing participation in breach of trust claim to lie. (Def. Br. 45–49.) This is not the legal standard.

In analyzing knowing participation claims, courts look to the nature of the relationship between the accountholder and his clients, and not to the putative title given to the bank account itself. *See, e.g.*, *Chaney*, 595 F.3d at 232–33 n.7. The *Chaney* court explicitly rejected JPMC's argument here that "under New York law a bank's liability as a participant in fiduciary misappropriation is limited to accounts denominated as fiduciary." *Id.* at 233 n.7. The New York Court of Appeals similarly held that the nature of funds held in a fiduciary capacity does not change when the funds are placed in the fiduciary's "individual bank account." *See Bischoff*, 218 N.Y. at 111; *see also, e.g.*, *Heffernan v. Marine Midland Bank, N.A.*, 267 A.D.2d 83, 84 (1st Dep't 1999) (allowing a knowing participation claim where the accounts at issue were the bank's customer's "personal accounts"); *Frawley v. Dawson*, 32 Misc. 3d 1207(A) *12–13 (Sup. Ct. Nassau Co. 2011) (allowing a knowing participation claim against a bank that maintained investment adviser's bank account). None of the cases JPMC cites address how the fiduciary status of a bank's customers impacts a plaintiff's claim for knowing participation. (*See* Def. Br. 45–49); *In re Agape Litig.*, 681 F. Supp. 2d at 360–61; *Renner*, 1999 WL 47239, at *1; *Rizer v. Breen*, 2007 N.Y. Misc. LEXIS 801, at *15–19 (Sup. Ct. N.Y. Co. Jan. 29, 2007).

Even if this Court were to find that the "nature" of the account was probative at the 12(b)(6) stage, JPMC acknowledges that this inquiry necessarily involves a question of fact. (*See* Def. Br. 48.) JPMC seeks to prove to the Court that the account was not a fiduciary account by attaching an undated signature card for the 703 Account. (*See* Def. Decl. Ex. 7.) JPMC seems to suggest that this signature demonstrates as a matter of law that the 703 Account was not a fiduciary account. (*See* Def. Br. 48.) But this document says nothing about the type of account opened. (*See* Def. Decl. Ex. 7.) In fact, it explicitly references other documents that do govern the nature of the account, but which JPMC has not attached and has not produced to the Trustee. (*Id.*) The nature of the 703 Account thus remains an unresolved question, and one which, on a motion to dismiss, must be resolved in favor of the non-moving party. *See Cargo Partner*, 352 F.3d at 44.

b. JPMC Knew a Fiduciary Relationship Existed Between BLMIS and Madoff and Their Customers

JPMC does not deny that the Trustee adequately alleged that JPMC knew that BLMIS and Madoff operated the IA business and thereby owed a fiduciary duty to their customers. (Am.

Compl. ¶¶ 190, 200, 242–43, 492, 497.) For instance, JPMC knew BLMIS and Madoff had discretionary control over BLMIS customers' accounts. (*See id.*) The Trustee's allegations establish that JPMC knew the 703 Account served the IA Business and held BLMIS customers' funds in trust. (*Id.* ¶ 200, 492.) It was in fact a matter of public record that Madoff, in his capacity as an investment adviser, held the position of trustee for numerous retirement accounts, pension plans and trusts. (*Id.* ¶ 200.)

In addition, since at least 2004, JPMC also received and reviewed Annual Audited Reports and FOCUS Reports from BLMIS that contained information about, among other things, the broker-dealer's cash flows, liabilities, and loan collateral. (*Id.* ¶¶ 216, 218–34, 493.)

c. JPMC Was on Notice that Madoff Was Misappropriating Funds Entrusted to Madoff and BLMIS Customers

The Trustee has adequately alleged that JPMC was on notice that Madoff was misappropriating customers' funds in breach of BLMIS's and Madoff's fiduciary duty. (Am. Compl. ¶¶ 190, 200, 242–43, 492, 497.) In response, JPMC focuses the Court's attention on an incorrect characterization of the knowledge requirement applicable to knowing participation claims. (*See* Def. Br. 34–37.) Despite JPMC's claims to the contrary, notice—and not "clear evidence" or actual knowledge—of the misappropriation is all that is required to state a claim for damages for participating in a breach of trust. *See Lerner*, 459 F.3d at 287–88; *Bischoff*, 218 N.Y. at 112; *Amoros*, 233 A.D.2d at 39.

Where a bank faces "[f]acts sufficient to cause a reasonably prudent person to suspect that trust funds are being misappropriated," that bank is on notice and must investigate. *Chaney*, 595 F.3d at 233; *Amoros*, 233 A.D.2d at 39. Regardless of whether the bank actually conducts such an inquiry, it is charged with the knowledge of facts that a reasonable inquiry would have revealed. *See Lerner*, 459 F.3d at 287–88; *Amoros*, 233 A.D.2d at 39; *Bonham*, 249 A.D. at 433. As the New York Appellate Division explained:

> [A bank] may not ignore acts by a trustee which indicate his malfeasance. If a depositary has actual or constructive knowledge of a course of dealing with trust funds by a trustee, of such a character as would lead a person of reasonable prudence and caution to suspect that trust funds then on deposit are about to be misappropriated, a duty is laid upon the depositary to make reasonable inquiry to ascertain the true facts. If it fails to make such an inquiry as a means of verifying or dispelling that suspicion, the depositary may be charged with knowledge of facts which reasonable inquiry would have revealed and it may be held responsible for loss resulting from the trustee's infidelity.

Newton v. Scott (*In re Bohenko Estate*), 254 A.D. 140, 143 (4th Dep't 1938).

JPMC again ignores the vast body of case law involving knowing participation and improperly focuses on the knowledge standard for aiding and abetting and on an isolated quote from *MLSMK* to support its proffered "clear evidence" standard. (Def. Br. 49.) But that language in *MLSMK* was referring to the portion of the *Lerner* decision discussing aiding and abetting breach of fiduciary duty, and not to the portion of the decision regarding knowing participation in a breach of trust. *See MLSMK*, 2011 WL 2176152, at *3 (citing *Lerner*, 459 F.3d at 295). And as explained above, the elements of a knowing participation claim are distinct from those for an aiding and abetting claim.

While New York courts and the Second Circuit have consistently held that notice of the misappropriation is sufficient to state a claim for knowing participation, the Trustee's claim succeeds even under the clear evidence standard. The Trustee has alleged facts sufficient to show that JPMC was not only on notice that Madoff was misappropriating the funds customers deposited in the 703 Account, but confronted clear evidence of that misappropriation sufficient to demonstrate its actual knowledge of the fraud.

d. JPMC Participated in Madoff's Misappropriation of Customer Property

Parroting its argument in support of dismissing the Trustee's aiding and abetting claims, JPMC asserts that the Trustee's claim requires proof of substantial assistance. (Def. Br. 49–51.) This is not the relevant standard for knowing participation claims. Rather, the Trustee need only allege that JPMC participated, along with Madoff, in the misappropriation of customer funds by benefiting from the diversion or failing to act after being on put on notice of the diversion. *See, e.g.*, *Lerner*, 459 F.3d at 287–88; *Bischoff*, 112 N.E. at 761. The Trustee has adequately alleged that JPMC "participated" under either prong.

First, the Trustee alleges that JPMC has acquired benefits through or from Madoff's diversion of BLMIS customer funds by taking BLMIS customers' money to satisfy a debt owed to it by BLMIS and by accepting and keeping other forms of payments from BLMIS such as fee and interest payments. (Am. Compl. ¶¶ 2, 276–77, 279, 284, 287–89, 537, 558, Ex. A.) Second, the Trustee alleges that JPMC joined in the diversion of funds by providing banking services to BLMIS and Madoff. (*Id.* ¶¶ 191, 196, 202, 504, 553.) Charged with the knowledge that these deposits and withdrawals were a breach of trust, JPMC is liable for knowingly participating in BLMIS's and Madoff's breach of trust. *See, e.g.*, *D.M. Rothman & Co.*, 411 F.3d at 99; *Bischoff*, 218 N.Y. at 112–13; *Am. Surety Co. of N.Y. v. First Nat'l Bank*, 141 F.2d 411, 415 (4th Cir. 1944).

JPMC also argues that the proximate cause and individual reliance are necessary elements of the Trustee's knowing participation claim. (*See* Def. Br. 51–53.) These allegations are directly contradicted by the controlling law in the Second Circuit and, unsurprisingly, JPMC does not cite any case law to support these arguments. *See, e.g.*, *Lerner*, 459 F.3d at 287–88.

D. The Trustee Has Sufficiently Alleged that JPMC Aided and Abetted Madoff's Fraud, Breach of Fiduciary Duty, and Conversion

To state a claim for aiding and abetting fraud under New York law, the Trustee must allege: (1) the existence of a fraud; (2) JPMC's knowledge of the fraud; and (3) that JPMC provided substantial assistance to advance the fraud's commission. *Lerner*, 459 F.3d at 292 (quoting *JPMorgan Chase Bank v. Winnick*, 406 F. Supp. 2d 247, 252 (S.D.N.Y. 2005)). Similarly, to state a claim for aiding and abetting breach of fiduciary duty the Trustee must allege: (1) a breach by a fiduciary of an obligation to another; (2) that JPMC knowingly induced or participated in the breach; and (3) BLMIS and/or its customers suffered damages as a result of the breach. *Lerner*, 459 F.3d at 294. A defendant participates in a breach of fiduciary duty when he or she provides substantial assistance to the primary violator. *Id.* Finally, to state a claim for aiding and abetting conversion the Trustee must allege: (1) conversion by Madoff; (2) knowledge of the conversion on the part of JPMC; and (3) substantial assistance by JPMC in Madoff's achievement of the conversion. *Dangerfield v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 02 Civ. 2561(KMW)(GW), 2006 WL 335357, at *5 (S.D.N.Y. Feb. 15, 2006).

The essence of JPMC's argument is that it would never have invested in BLMIS feeder funds or provided banking services to BLMIS had it known Madoff was operating a Ponzi scheme. (Def. Br. 32–52, 55.) But the facts alleged in the Amended Complaint show that JPMC actually knew that Madoff was engaging in fraud and lying to his regulator, that it knew the entire operation at BLMIS was a scam because it could not pass even rudimentary diligence, and even that individual employees were "not surprised" that Madoff was a fraud. (*See, e.g.*, Am. Compl. ¶¶ 11, 165, 511–17, 525–32, 546–52.) As to JPMC's motives in knowingly investing in and servicing a fraud, no speculation is necessary. The Trustee has alleged that JPMC performed a risk/benefit calculation when it decided to invest with Madoff. (*See, e.g.*, *id*. ¶ 124 (speculating that "it would take [a] . . . fraud in the order of $3bn or more . . . for JPMC to be affected").) That JPMC miscalculated is irrelevant.

1. Conscious Avoidance of Fraud Is Equivalent to Actual Knowledge

While actual, not constructive, knowledge is required for aiding and abetting liability, JPMC misapprehends the definition of actual knowledge. (*See* Def. Br. 34–49.) The majority of courts in the Second Circuit recognize that willful blindness or conscious avoidance constitutes actual knowledge. *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC*, 479 F. Supp. 2d 349, 367–68 (S.D.N.Y. 2007); *Cromer Fin. Ltd. v. Berger*, No. 00 Civ.2284 DLG, 2003 WL 21436164, at *9 (S.D.N.Y. June 23, 2003).

In *Fraternity Fund*, investors in several hedge funds brought an action against the funds' brokers for aiding and abetting the hedge fund managers' fraud and breaches of fiduciary duties. 479 F. Supp. 2d at 351. In rejecting the broker's motion to dismiss, Judge Kaplan explained the difference between constructive knowledge and conscious avoidance:

> Constructive knowledge is knowledge that one using reasonable care or diligence should have, and therefore that is attributed by law to a given person. *Conscious avoidance*, on the other hand, *occurs when it can almost be said that the defendant actually knew because he or she suspected a fact and realized its probability, but refrained from confirming it in order later to be able to deny knowledge.* Conscious avoidance therefore involves a culpable state of mind whereas constructive knowledge imputes a state of mind on a theory of negligence.

Id. at 368 (emphasis added) (internal citations and quotations omitted); *see also Cromer Fin.*, 2003 WL 21436164, at *9 (reasoning that "there is no reason to believe that New York law would not accept willful blindness as a substitute for actual knowledge in connection with aiding and abetting claims"). The Second Circuit has held willful blindness sufficient to establish liability for criminal aiding and abetting. *Fraternity Fund*, 479 F. Supp. 2d at 368. Thus, there is no rational reason to spare a civil defendant that consciously avoids confirming the fraudulent nature of the endeavor it furthers.

JPMC's reliance on *In re Agape* is misplaced. (Def. Br. 34–35) (citing *Clarke v. Cosmo* (*In re Agape Litig.*), 773 F. Supp. 2d 298, 308 (E.D.N.Y. 2011.)) The *In re Agape* court began its analysis by explaining that evidence of recklessness, conscious avoidance, and willful blindness was historically not enough to satisfy the actual knowledge element. 773 F. Supp. 2d at 308. But the court ultimately adopted the conscious avoidance standard of actual knowledge in light of *Fraternity Fund*. *Id.* at 308–09. The court recognized that since *Fraternity Fund*, many courts adjudicating whether a plaintiff has pled actual knowledge on an aiding and abetting claim have adopted a willful blindness or conscious avoidance standard. *Id.* (citing *Kirschner v. Bennett (In re Refco Secs. Litig.)*, 759 F. Supp. 2d 301, 334 (S.D.N.Y. 2010); *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 443 (S.D.N.Y. 2010); *Kirschner v. Bennett*, 648 F. Supp. 2d 525, 544 (S.D.N.Y. 2009)).

Specifically in the context of Madoff's Ponzi scheme, aiding and abetting allegations based on willful blindness have been found sufficient to meet FRCP 9(b)'s heightened pleading standard. *See Anwar*, 728 F. Supp. 2d at 442–43 ("Given the [defendants'] familiarity with the [f]unds, as well as their general experience in providing financial services to funds, and their knowledge of these red flags," plaintiffs had alleged a strong inference that fund custodians had consciously avoided confirming the fraud); *see also Lautenberg Found. v. Madoff*, Civ. Act. No. 09-816 (SRC), 2009 WL 2928913, at *16–17 (D.N.J. Sept. 9, 2009) ("a strong inference that Peter Madoff knew that B[L]MIS was engaged in a massive fraudulent scheme" or "at the very least [was] willfully blind" to it).

2. The Trustee Has Alleged JPMC's Actual Knowledge of Fraud

Furthermore, the Trustee has alleged that JPMC had actual knowledge of Madoff's fraud as well. Actual knowledge does not require the Trustee to produce the "defendant's explicit acknowledgement of the fraud." *See Nathel v. Siegal*, 592 F. Supp. 2d 452, 468 (S.D.N.Y. 2008). Actual knowledge of a fraud may be "divined from surrounding circumstances." *Anwar*, 728 F. Supp. 2d at 442–43 (quoting *Fraternity Fund*, 479 F. Supp. 2d at 368).

For example, in *Winnick*, a telecommunications company was accused of inflating earnings through bogus network capacity swaps with other providers. 406 F. Supp. 2d at 249. Banks that had extended loans to the telecommunications company brought an aiding and abetting fraud claim against the general counsel of the company. *Id.* at 250. Denying the general counsel's motion to dismiss, the court held that allegations that the general counsel had participated in transactions core to the fraudulent scheme, and had been copied on three e-mails stating that the company was "taking capacity" in order to meet revenue targets, were sufficient to establish actual knowledge. *Id.* at 254. The court reasoned:

> Perhaps [the vice president's] three emails can and will be read by the factfinder in the manner suggested [by the general counsel, i.e. insufficient to demonstrate actual knowledge], but at this early stage of the litigation it is sufficient that they can also be read to inform her of the fraudulent purpose of the transactions. A more substantial factual basis is not required to give rise to a strong inference of [the general counsel's] actual knowledge.

Id. at 255.

JPMC relies on a number of cases in which aiding and abetting claims against banks were dismissed because the allegations of suspicious activity in the accounts were not sufficient to elevate the plaintiffs' claims from constructive knowledge to actual knowledge, which is not the case on the facts alleged here, and these cases are thus inapposite. *See Schmidt v. Fleet Bank*, 1998 WL 47827, at *6 (S.D.N.Y. Feb. 4, 1998) (bank holding escrow and IOLA account not charged with scienter based on allegations that it knew or should have known that perpetrator created fictitious entities, paid bad checks, and failed to notify the appropriate state regulatory entity); *Rosner v. Bank of China*, 2008 WL 5416380, at *6 (S.D.N.Y. Dec. 18, 2008) (allegations that bank teller observed repeated transfers and withdrawals of large sums of cash that were inconsistent with the nature of the perpetrator's business insufficient to elevate constructive knowledge of money laundering to actual knowledge); *Berman v. Morgan Keegan & Co.*, No. 10 Civ. 586 (PKC), 2011 WL 1002683, at *12 (S.D.N.Y. Mar. 14, 2011) (conclusory allegation that a broker-dealer knew of fraudulent activity because of a printout from a fraudulent company's website and its "Know Your Customer" and stock exchange rules did not suffice to demonstrate actual knowledge). *MLSMK Invs. Co. v. JP Morgan Chase & Co.*, 737 F. Supp. 2d 137, 144–45 (S.D.N.Y. 2010) (finding plaintiff's conclusory allegations regarding defendant's knowledge of Madoff's fraud insufficient to establish actual knowledge). For example, in *MLSMK*, a financial services firm that invested its clients' money with BLMIS filed an action against JPMC asserting, *inter alia*, aiding and abetting claims. 737 F. Supp. 2d at 140–41. In opposing JPMC's motion to dismiss, the plaintiff argued that the existence of nondescript "unusual" transactions in the 703 Account and JPMC's withdrawal of its investments in BLMIS feeder funds in 2008—standing alone—evidenced JPMC's knowledge of the Ponzi scheme. *Id.* at 143–44. The court disagreed, finding plaintiff's allegations conclusory and speculative. *Id.* at 144. Notably, in affirming the dismissal the Second Circuit noted that the plaintiff had identified newly discovered evidence at oral argument, and clarified that nothing in its opinion should be interpreted to prejudice the plaintiff from moving to reopen the case. *MLSMK Invs. Co. v. JP Morgan Chase & Co.*, No. 10-3040-cv, 2011 WL 2176152, at *4 (2d Cir. June 6, 2011). Because the Trustee's allegations here are far more detailed and specific than the allegations set forth in the *MLSMK* plaintiff's 33-page complaint, the court's opinion in *MLSMK* does not support the dismissal of the Trustee's claims.

Contrary to JPMC's attempt to separate out the Trustee's allegations into separate "sets" depending on which products or services the allegations relate to (Def. Br. 35), the relevant question on this motion to dismiss is whether the Trustee's allegations, when considered as a whole and with all reasonable inferences drawn in the Trustee's favor, state a plausible inference that JPMC should be charged with actual knowledge of Madoff's fraud. *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009); *Pereira v. Grecogas Ltd.* (*In re Saba Enters., Inc*.), 421 B.R. 626, 638–39 (Bankr. S.D.N.Y. 2009). Other than an explicit admission by JPMC's CEO that Madoff was engaged in a Ponzi scheme, it is difficult to imagine "surrounding circumstances" more damning than those that existed here. *See Anwar*, 728 F. Supp. 2d 442–43; *see also Ouster v. Kirschner*, 905 N.Y.S. 2d 69, 72 (1st Dep't 2010) ("Participants in a fraud do not affirmatively declare to the world that they are engaged in the perpetuation of a fraud.").

3. The Trustee Has Sufficiently Pleaded that JPMC Substantially Assisted Madoff in Committing a Massive Fraud, Breach of Fiduciary Duty, and Conversion

JPMC also argues that the Trustee has failed to adequately plead that it substantially assisted Madoff in the commission of his fraud, breach of fiduciary duty, and conversion. (Def. Br. 49–53.) Again, JPMC's argument fails.

Substantial assistance exists where a defendant affirmatively assists, helps conceal, or by virtue of failing to act when required to do so, enables the fraud. *Allied Irish Banks, P.L.C. v. Bank of Am. N.A.*, No. 03 Civ. 3748(DAB), 2006 WL 278138, at *12 (S.D.N.Y. Feb. 2, 2006) (internal citations omitted). A plaintiff does not have to allege that he or she dealt directly with the aider and abettor to sustain the substantial assistance element of an aiding and abetting claim. *Nathel*, 592 F. Supp. 2d at 470. Moreover, the test for whether assistance is "substantial" does not turn on how unusual or routine the conduct was from the perspective of the aidor and abettor, but how substantially the conduct contributed to the perpetration of the underlying tort. *Winnick*, 406 F. Supp. 2d at 257; *Univ. of Montreal Pension Plan*, 652 F. Supp. 2d at 511. Finally, a plaintiff must allege that the defendant's substantial assistance proximately caused the harm on which the primary liability is predicated, in that its injury was a direct or reasonably foreseeable result of the conduct. *Fraternity Fund*, 479 F. Supp. 2d at 370–71 (internal citations omitted); *see Lerner*, 459 F.3d at 283.[12]

JPMC substantially assisted Madoff's fraud in many ways. As discussed above, it affirmatively assisted Madoff by allowing him to use the 703 Account—an account in which funds were not segregated or transferred into separate sub-accounts—for more than 20 years to run the Ponzi scheme. (Am. Compl. ¶¶ 1–2, 4, 518), funneling hundreds of millions of dollars into BLMIS through investments and loans (*id.* ¶¶ 3, 116–24, 273–95, 518), executing transfers and handwritten checks for tens of millions of dollars that were necessary for the operation of the Ponzi scheme, and providing unsupervised Private Bank accounts to some of Madoff's biggest customers. (*Id.* ¶¶ 240–59, 518.)

JPMC failed to act when required to do so. For instance, JPMC ignored its affirmative duty not to participate in a fraud in light of its knowledge of Madoff's fiduciary obligations to his customers and that Madoff was misappropriating funds. *Chaney*, 595 F.3d at 232–33; *Lerner*, 459 F.3d at 288–90. By failing to act, JPMC substantially assisted Madoff in his fraud, breach of

[12] Although JPMC treats substantial assistance and proximate causation as separate elements of an aiding and abetting claim, (*see* Def. Br. 49–53,) they are in fact a single element: to have substantially assisted a fraud requires proximate causation. *See, e.g.*, *Fraternity Fund,* 479 F. Supp. 2d at 370–71; *Lerner,* 459 F.3d at 283. While proximate cause is an issue of fact that is properly resolved after development of a fact record, *Winnick*, 406 F. Supp. 2d at 256–57, the Trustee has alleged that JPMC's assistance to Madoff was the direct and proximate cause of the harm to BLMIS and its customers. (Am. Compl. ¶¶ 518–19, 533–34, 553–54.)

fiduciary duty and conversion of customer property. JPMC failed to act when it chose not to execute its anti-money laundering policy—which it touted to customers—by effectively failing to provide an account sponsor for the 703 Account (Am. Compl. ¶¶ 214–16); and ignoring over ninety instances of the irregular activity in the 703 Account and dismissed one alert that was issued in January 2007. (*Id*. ¶¶ 260–63.) For instance, JPMC ignored false statements made by Madoff through BLMIS in regulatory filings (*id.* ¶¶ 217–39), and dismissed a rumor that there was a well-known cloud over the head of Madoff and his returns were speculated to be part of a Ponzi scheme after having “one of the juniors look into this rumor about Madoff” with a simple Google search and no follow-up. (*Id.* ¶¶ 119–23.)

Finally, JPMC’s assistance proximately, directly, and foreseeably harmed BLMIS and its investors. The Trustee’s theory of proximate causation is not “that Madoff could not have run his Ponzi scheme without the commercial banking services provided by JPMorgan.” (Def. Br. 51.) The provision of “commercial banking services” alone would not have sufficed to enable Madoff to run his Ponzi scheme. JPMC also actually knew about, or consciously avoided, evident fraudulent activity occurring in the 703 Account, and failed to act when required to do so, allowing Madoff to keep the Ponzi scheme going and deepening the insolvency that caused BLMIS customers to lose billions of dollars. (Am. Compl. ¶¶ 119–23, 214–39, 260–63.) As set forth in the Amended Complaint and summarized above, JPMC permitted Madoff and its Private Banking customers to engage in evident fraudulent transactions, fed $250 million to BLMIS feeder funds, and lent hundreds of millions of dollars more to Madoff through BLMIS and Levy. (*Id*. ¶¶ 178, 248–59, 273–95.) Furthermore, and most importantly, proximate causation is an issue of fact that should be resolved after development of the record. *See, e.g.*, *Winnick*, 406 F. Supp. 2d at 256–58.

4. The Trustee Has Adequately Pled Madoff's Underlying Fraud

JPMC contends that the primary fraud as to each and every customer is not pled. (Def. Br. 52–53.) This argument has no merit.

As courts have recognized, "the basic facts surrounding Madoff's historic Ponzi scheme are by now well known." *J.P. Jeanneret Assocs.*, 769 F. Supp. 2d at 347 (citing *In re Beacon Assocs. Litig.*, 745 F. Supp. 2d 386 (S.D.N.Y. 2010)). Where a fraudulent scheme has been revealed to the public at large, courts assume the first element of an aiding and abetting fraud claim has been satisfied. *See, e.g.*, *Lerner,* 459 F.3d at 273; *Allied Irish Banks,* 2006 WL 278138, at *11. Here, the Trustee's Amended Complaint contains detailed allegations explaining how Madoff executed his Ponzi scheme through the investment advisory arm of BLMIS. (Am. Compl. ¶¶ 36–52.) The fraud at issue is the Ponzi scheme by which Madoff generated false written customer statements that reflected false profits and investments designed to encourage doing business with BLMIS. The Trustee thus has alleged that the harm caused by JPMC's conduct was generalized to, and caused the same harm to, each and every customer and creditor of BLMIS.[13]

5. The Trustee Properly Relies Upon a Suspicious Activity Report that Has Been Made Public

Among his allegations supporting JPMC's knowledge, the Trustee sets forth a suspicious activity report ("SAR") which JPMC filed with the UK authorities just prior to Madoff's arrest. (Am. Compl. ¶¶ 11–12.) The SAR demonstrates on its face that JPMC had actual knowledge of Madoff's fraud stating, among other things, that Madoff's returns were "too good to be true." (*Id.*) Knowing the damaging nature of this document, JPMC seeks to have it stricken from the

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[13] Should the court determine that specific allegations are required as to each customer, the Trustee would respectfully request leave to replead.

Amended Complaint. (Def. Br. 42–43.) JPMC argues that the Trustee's reliance on the SAR violates federal law and policy. (*Id.*) JPMC is mistaken.

First, the SAR is a public document which was made public by the French press before the Trustee filed his initial Complaint. (Am. Compl. ¶ 11;) Benjamin Masse-Stamberger, *THE MADOFF AFFAIR: the secret report accusing JPMorgan*, L'Express.fr, Oct. 7, 2010. ABC News also reported on and published the SAR, in its entirety, on its webpage. Anna Schecter, *JP Morgan Suspected Madoff Months Prior to Arrest, Kept Doing Business With Him*, ABC News, Dec. 2, 2010, *available at* http://abcnews.go.com/Blotter/jp-morgan-suspected-madoff-months-prior-arrest/story?id=12294368&paged. The Trustee is entitled to rely on this public document to form the allegations in the Amended Complaint. *See In re Marsh & McLennan Cos. Sec. Litig.*, No. MDL 1744, 04 CIV 8144 SWK, 2006 WL 2789860, at *2 (S.D.N.Y. Sept. 27, 2006); *In re Merck & Co., Inc. Sec. Derivative & "ERISA" Litig.*, 543 F.3d 150, 154 n.2 (3d Cir. 2008).

Seeking to avoid the import of its statements, JPMC impliedly challenges the SAR's admissibility. (*See* Def. Br. 42–43.) But this Circuit has held that the admissibility of a document incorporated into a complaint is irrelevant on a motion to dismiss. *Ricciuti v. N.Y.C. Transit Auth.*, 941 F.2d 119, 123–24 (2d Cir. 1991); *New Yuen Fat Garments Factory Ltd. v. August Silk Inc.*, No. 07 Civ. 8304 (JFK), 2009 WL 1515696, at *6 (S.D.N.Y. June 1, 2009). It is inappropriate to "assay the weight of the evidence" on a motion to dismiss. *Geisler v. Petrocelli*, 616 F.2d 636, 639 (2d Cir. 1980). Only the legal feasibility of a complaint should be considered. *Id.*

JPMC's reliance on *Lee v. Bankers Trust Co.*, 166 F.3d 540 (2d Cir. 1999) is unavailing. (*See* Def. Br. 42–43.) JPMC cites to this case to argue that 31 U.S.C. § 5318(g)(3) creates an "unqualified privilege" of "immunity from any law" for any statement in a SAR. (Def. Br. 42–

43), citing *Lee*, 166 F.3d at 544.) But *Lee* concerned a defamation claim brought by the subject of a SAR against the bank that filed it. 166 F.3d at 542–43. Here, the Trustee relies on a public document and is not arguing that JPMC defamed Madoff or BLMIS in the SAR. (*See* Am. Compl. ¶ 11.) And the Trustee's claim for liability is not based solely on statements JPMC made in the SAR. (*See generally* Am. Compl.; *see Bizcapital Bus. & Indust. Dev. Corp. v. Comptroller for the Currency of the U.S.*, 406 F. Supp. 2d 688, 694 (E.D. La. 2005) (safe harbor provision not implicated where a plaintiff sought information about a SAR to prove liability, not as the basis for liability), *vacated in part and remanded*, 467 F.3d 871 (5th Cir. 2006) (remanding OCC's decision denying a financial institution's request for a SAR).) The statutory safe harbor provision implicated in the *Lee* case is thus not pertinent here.[14]

E. The Trustee Has Adequately Alleged That JPMC Was Unjustly Enriched With Customer Property

To adequately plead a claim for unjust enrichment, the Trustee must allege only that (1) JPMC received a benefit; (2) at the expense of BLMIS and/or its customers; and (3) equity and good conscience require restitution. *Kaye v. Grossman*, 202 F.3d 611, 616 (2d Cir. 2000) (citing *Dolmetta v. Uintah Nat'l Corp.*, 712 F.2d 15, 20 (2d. Cir. 1983)); *Frito-Lay, Inc. v. LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 10 F.3d 944, 957–58 (2d Cir. 1993) (citing *Miller v. Schloss*, 113 N.E. 337, 339 (N.Y. 1916)). "The 'essence' of such a claim 'is that one party has received money or a benefit at the expense of another.'" *Kaye*, 202 F.3d at 616 (quoting *City of Syracuse v. R.A.C. Holding, Inc.*, 685 N.Y.S.2d 381, 381 (4th Dep't 1999)). JPMC, as BLMIS's lender and investor, unjustly acquired customer property and accrued millions of dollars in fees and profits at the expense of BLMIS customers.

[14] For the same reasons, the policy considerations discussed in another defamation case, *Nevin v. Citibank, N.A.*, 107 F. Supp. 2d 333, 340–42 (S.D.N.Y. 2000) (McMahon, J.), do not apply here.

1. The Trustee Need Not Allege Direct Dealings Between JPMC and BLMIS Customers to Sustain a Claim for Unjust Enrichment

JPMC argues that the Trustee's unjust enrichment claim should be dismissed because the Trustee has not alleged any direct dealings or nexus between JPMC and BLMIS customers. (Def. Br. 56.) JPMC misstates the law. New York law does not require a plaintiff to allege "direct dealings" or a nexus between the plaintiff and the defendant. *See, e.g., Dreieck Finanz AG v. Sun*, No. 89 CIV. 4347(MBM), 1989 WL 96626, at *4 (S.D.N.Y. Aug. 14, 1989) (citing *Davenport v. Walker*, 116 N.Y.S. 411 (2d Dep't 1909)); *T.D. Bank, N.A. v. JP Morgan Chase Bank, N.A.*, No. 10-CV-2843 (JG)(ARL), 2010 WL 4038826, at *5 (E.D.N.Y. Oct. 14, 2010); *Cox v. Microsoft Corp.*, 778 N.Y.S.2d 147, 149 (1st Dep't 2004). The notion that direct dealings are required to plead an unjust enrichment claim is antithetical to the notion that unjust enrichment applies in the absence of any agreement, "when and because the acts of the parties *or others* have placed in the possession of one person money, or its equivalent, under such circumstances that in equity and good conscience he ought not to retain it." *Saunders v. Kline*, 391 N.Y.S.2d 1, 1–2 (1st Dep't 1977) (citing *Miller*, 218 N.Y. at 407) (emphasis added). This is particularly true where, as here, the Trustee seeks to recover stolen money that ultimately landed in JPMC's possession. *See, e.g., T.D. Bank*, 2010 WL 4038826, at *5 (citing *Newton v. Porter*, 69 N.Y. 133, 136 (1887)); *see also Newbro v. Freed*, 06-1722-CV, 2007 WL 642941, at *2 (2d Cir. Feb. 27, 2007).

Even if New York law required direct dealings or a nexus, the Trustee's allegations satisfy that standard. JPMC relies on inapposite cases which involved commercial disputes between competitors[15] and claims in which the connection between the plaintiff's harm and the

[15] *See Czech Beer Imps., Inc. v. C. Haven Imps., LLC*, No. 04 Civ. 2270 (RCC), 2005 WL 1490097, at *1–2 (S.D.N.Y. June 23, 2005) (beer distributor's claim against competitor to whom brewery had allegedly granted rights in violation of exclusivity agreement); *Reading Int'l, Inc. v.*

defendants was absurdly attenuated.[16] (*See* Def. Br. 56–57.) Here, by contrast, the harm that JPMC caused BLMIS customers, and the nexus between them, is direct: JPMC is holding money that was stolen from BLMIS customers. (Am. Compl. ¶ 52, Ex. A.) JPMC received this money knowing that it belonged to customers and that Madoff was engaged in a fraud—a fraud that JPMC enabled. (*See, e.g.*, *id.* ¶ 200.) This is a sufficient nexus to state a claim for unjust enrichment.

2. Equity and Good Conscience Require Restitution

JPMC further argues that equity and good conscience do not require restitution because the Trustee does not allege that BLMIS customers "invested funds for the benefit of, or at the behest of, JPMorgan." (Def. Br. 57.) But unjust enrichment law does not confine JPMC's liability to these limited circumstances. That BLMIS customers invested money for their own benefit does not defeat the Trustee's claim. Courts consistently uphold unjust enrichment claims against persons who receive property stolen from a party with whom they had no relationship. *See, e.g.*, *T.D. Bank*, 2010 WL 4038826, at *5–6; *Hecht v. Malvern Preparatory Sch.*, 716 F. Supp. 2d 395, 403 (E.D. Pa. 2010).[17]

Oaktree Capital Mgmt. LLC, 317 F. Supp. 2d 301, 307–09 (S.D.N.Y. 2003) (theater owner's claim against competitors based on alleged restraint of trade).

[16] *See Carmona v. Spanish Broad. Sys., Inc.*, No. 08 Civ. 4475 (LAK), 2009 WL 890054, at *1, *6 (S.D.N.Y. Mar. 30, 2009) (radio station not liable for travel agency's false advertisement of all inclusive vacation where listeners paid the agency, not the station); *Jet Star Enters., Ltd. v. Soros*, No. 05 CIV. 6585(HB), 2006 WL 2270375, at *1–2, *5 (S.D.N.Y. Aug. 9, 2006) (plaintiff could not collect on default judgment against CS Aviation by suing the lending bank for other entities owned by CS Aviation's founders when the bank never received money from or on behalf of the liable entity).

[17] The cases upon which JPMC relies are factually distinguishable. Neither of these cases involved stolen property. *Kagan v. K-Tel Entm't, Inc.*, 172 A.D.2d 375, 376 (1st Dep't 1991) (dismissing plaintiffs' unjust enrichment claim against television distributor for money owed to plaintiffs by third-party producer); *Piccoli A/S v. Calvin Klein Jeanswear Co.*, 19 F. Supp. 2d 157, 166 (S.D.N.Y. 1998) (relying on *dicta* in *Kagan* in dismissing clothing licensee's claim for

Jackson v. Regions Bank, No. 3:09-00908, 2010 WL 3069844 (M.D. Tenn. Aug. 4, 2010) is particularly instructive. There, the plaintiffs, like BLMIS customers, had lost money by investing with a broker-dealer perpetuating a fraud scheme. *Id.* at *1–2. Plaintiffs commenced an action against the broker-dealer's bank claiming that the bank had failed to adequately monitor the broker-dealer's accounts and had wrongfully ignored "numerous red flags." *Id.* at *3–4. The court found that the fees assessed on the account by the bank constituted a benefit to the bank sufficient to support plaintiffs' unjust enrichment claim, even though the benefit was not conferred directly by plaintiffs. *Id.* at *10–11. Even more than the bank in *Jackson*, JPMC wrongfully profited from a fraud and may not retain its winnings.

F. The Trustee Has Sufficiently Alleged That JPMC Wrongfully Converted Customer Property

JPMC also moves to dismiss the Trustee's conversion claim, which seeks recourse for JPMC's wrongful debit of customer property from the 703 Account. (Am. Compl. ¶ 537.) The elements of a claim for conversion are "(1) plaintiff's possessory right or interest in the property . . . and (2) defendant's dominion over the property or interference with it, in derogation of plaintiff's rights." *Kiewit Constructors, Inc. v. Franbilt, Inc.*, No. 07-CV-121A, 2007 WL 2461919, at *2 (W.D.N.Y. Aug. 24, 2007) (citing *Colavito v. N.Y. Organ Donor Network, Inc.*, 8 N.Y.3d 43, 50 (2006)).

1. Whether BLMIS Customers Demanded Their Property from JPMC Has No Bearing on the Trustee's Claim

JPMC seeks dismissal of the Trustee's conversion claim for failing to "allege that [JPMC] withheld money in the face of a demand for its return." (Def. Br. 54–55.) However, any such allegation would be irrelevant to the Trustee's conversion claim, which is that JPMC has

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unjust enrichment against competitor which sought to recover the profits competitor earned allegedly as a result of licensee's work to create a higher demand for the product).

wrongfully *taken* customer property, not unlawfully retained it. *See Newbro v. Freed*, 409 F. Supp. 2d 386, 394 (S.D.N.Y. 2006) ("New York distinguishes claims that the defendant wrongfully detained—in contrast to having wrongfully taken—the property in question.").

Because the property at issue here was wrongfully taken, it is sufficient that the Trustee has alleged that: (1) the property at issue is a specific identifiable thing; (2) BLMIS customers had ownership, possession, or control over the property prior to its conversion; and (3) JPMC exercised unauthorized dominion over the property in question, to the alteration of its condition or to the exclusion of BLMIS customers' rights. *See Kirschner*, 648 F. Supp. 2d at 540. Whether BLMIS customers made a demand for the property's return is of no consequence.

2. BLMIS Customers' Money Is Specifically Identifiable

JPMC argues that the customer property subject to JPMC's alleged conversion is not specifically identifiable and thus violates the "general deposit rule." (Def. Br. 54.) However, numerous New York courts have declined to apply the general deposit rule, upholding conversion claims so long as the plaintiff identifies funds of a specific, named bank account, as the Trustee has done here. (Am. Compl. ¶¶ 2, 199, 279, 283, 286, 288, 537.) *See, e.g.*, *LoPresti v. Terwilliger*, 126 F.3d 34 (2d Cir. 1997); *Eastman Kodak Co. v. Camarata*, No. 05-CV-6384L, 2006 WL 3538944, at *13–14 (W.D.N.Y. Dec. 6, 2006); *Republic of Haiti v. Duvalier*, 211 A.D.2d 379, 384 (1st Dep't 1995); *Mfrs. Hanover Trust Co. v. Chem. Bank*, 160 A.D.2d 113 (1st Dep't 1990); *Grunfeld v. Kasnett*, 18 Misc. 3d 1143(A), at *3 (Kings County Sup. Ct. 2008); *see also Newbro*, 409 F. Supp. 2d at 395; *Kirschner*, 648 F. Supp. 2d at 542. Moreover, the general deposit rule does not apply in this context. Courts applying this rule do so in actions commenced by a depositor against the depository bank. *See, e.g.*, *Wells v. Bank of N.Y. Co., Inc.*, 694 N.Y.S.2d 570, 577 (Sup. Ct. N.Y. County 1999). As the court in *Newbro* explained, "[t]he rationale for this rule is that funds deposited with a bank become an asset of the bank, and the bank, in turn, becomes indebted to the depositor. Ordinarily, when the bank has misused the depositor's money, the depositor's remedy lies in contract—not tort." *Newbro*, 409 F. Supp. 2d at 395–96 (internal citation omitted); *see also Eastman Kodak*, 2006 WL 3538944, at *13; *Kirschner*, 648 F. Supp. 2d at 542. Because BLMIS customers were not depositors, they have no recovery against JPMC in contract for misusing customer property.

The court in *Kirschner* recognized the inapplicability of the general deposit rule in a similar context. In that case, the bankruptcy trustee sued the debtor's insiders and directors for their alleged participation in the debtor's fraud scheme. 648 F. Supp. 2d at 528–33. On behalf of the debtor's investors, the trustee asserted a cause of action for conversion, alleging that defendants had diverted assets from investors' accounts. *Id.* at 540–44. Because the trustee was bringing an action against aiders-and-abettors and the investors had no remedy in contract, the court concluded that "'the rationale underlying courts' reluctance to permit customers to proceed against the depository institution on a conversion theory does not apply.'" *Id.* at 543 (quoting *Newbro*, 409 F. Supp. 2d at 395–96). Similarly here, the Trustee asserts his conversion claim against an aider and abettor and has no claim sounding in contract. The general deposit rule is thus inapplicable.

3. JPMC Exercised Dominion and Control over BLMIS Customers' Money in Derogation of Their Rights

JPMC further argues that it did not exercise unauthorized dominion and control over customer property, as it debited money from the 703 Account on BLMIS's authorization. (Def. Br. 54.) However, that Madoff authorized JPMC's actions is irrelevant, as JPMC was on notice that the funds in the 703 Account belonged to BLMIS customers. (*See, e.g.*, Am. Compl. ¶¶ 200, 291.) New York law prohibits banks from using deposited funds to satisfy debts owed by a depositor, with knowledge that the deposited funds belong to a third party. *See Daly v. Atlantic*

Bank of N.Y., 201 A.D.2d 128, 129 (1st Dep't 1994); *see also United States v. Bank of Am.*, No. 06CV711A, 2009 WL 2009022, at *6 (W.D.N.Y. Feb. 20, 2009); 9 N.Y. Jur. 2d *Banks* § 308 (2011). "A bank will be considered to have such notice when it is aware of facts which would fairly provoke it to inquire as to the true ownership of the funds and such inquiry, if made with ordinary diligence, would reveal the true ownership." *Daly*, 201 A.D.2d at 129–30.

Finally, JPMC contends that the Trustee has failed to plead that JPMC intentionally deprived BLMIS customers of their property. (Def. Br. 54.) Citing Rule 9(b), JPMC asserts that the Trustee's failure to plead fraudulent intent is fatal to his conversion claim. However, not only is 9(b) relaxed with regard to bankruptcy trustees, but the Trustee's claim for conversion is not predicated on fraud.

G. The Trustee Has Sufficiently Alleged Fraud on the Regulator

JPMC requests dismissal of the fraud on the regulator claim, asserting that it is a "made up" cause of action and, even if it exists, the Trustee has failed to plead the requisite elements. (Def. Br. 58–60.) JPMC is mistaken.

A plaintiff states a claim for fraud on the regulator when it alleges a common law fraud committed by the defendant against a regulatory body, and that this fraud caused damage to the plaintiff. *See, e.g.*, *Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341, 343 (2001); *Minihane v. Weissman* (*In re Empire Blue Cross & Blue Shield Customer Litig.*), 622 N.Y.S.2d 843, 845 (Sup. Ct. N.Y. County 1994). Contrary to JPMC's position, the Second Circuit has not rejected the existence of this claim. In *BDO Seidman*, the Second Circuit rejected the plaintiff's claim for fraud upon the SEC not because the claim failed to exist, but rather, the Court found that the plaintiff in that case had failed to establish the requisite element of reliance. *BDO Seidman*, 222 F.3d at 71–73 (2d Cir. 2000).

1. The Trustee Has Alleged the Elements of Common Law Fraud

To state a claim for common law fraud in New York, a plaintiff must allege that: (1) a defendant misrepresented a material fact; (2) the defendant knew it was false; (3) the misrepresentation was made intentionally in order to defraud or mislead; (4) the plaintiff reasonably relied upon the misrepresentation; and (5) the plaintiff suffered damage. *See e.g.*, *Chanayil v. Gulati*, 169 F.3d 168, 171 (2d Cir. 1999); *Ross v Louise Wise Serv., Inc*., 836 N.Y.S.2d 509, 515 (N.Y. 2007) (internal citations omitted).

Fraud can also be based on information that a defendant has failed to disclose. *Woodhams v. Allstate Fire & Casualty Co.*, 748 F. Supp. 2d 211, 221–22 (S.D.N.Y. 2010) (internal citation omitted); *P.T. Bank Central Asia v. ABN Amro Bank N.V.*, 754 N.Y.S.2d 245, 250 (1st Dep't 2003). When fraud is based on an omission, the plaintiff must allege the defendant's underlying duty to disclose. *Woodhams*, 748 F. Supp. 2d at 221–22 (internal citation omitted); *P.T. Bank Central Asia*, 754 N.Y.S.2d at 250. In such cases, a plaintiff may be unable to state the facts constituting fraud in detail because such facts are necessarily within the knowledge of the defrauding party. *Kaufman v. Cohen*, 760 N.Y.S.2d 157, 166 (1st Dep't 2003). Under these circumstances, allegations based on information and belief are sufficient. *Fraternity Fund*, 376 F. Supp. 2d at 394; *Novak*, 216 F.3d at 312; *Paolucci*, 903 N.Y.S.2d at 587. Moreover, as discussed above, a trustee need not meet Rule 9(b) requirements.

JPMC argues that it did not knowingly make false representations. (Def. Br. 59.) The strength of the requisite inference for establishing that a defendant knowingly misrepresented or omitted information will vary by case, making it important to consider the information available at the time of the defendant's misrepresentation or omission. *See Eurycleia Partners*, 883 N.Y.S.2d at 151. Plaintiffs are not required to plead defendant's actual knowledge, s*ee JP Morgan Chase Bank v. Winnick*, 406 F. Supp. 2d 247, 253 n.4 (S.D.N.Y. 2005), because such information is within the sole knowledge of the defendant and therefore "least amenable to direct proof." *Houbigant, Inc. v. Deloitte & Touche LLP*, 753 N.Y.S.2d 493, 498 (1st Dep't 2003).

Here, the Trustee's allegations more than give rise to a reasonable inference that JPMC knew its representations and omissions to federal and state regulators were false. As detailed in the Amended Complaint and summarized above, the Trustee has established that JPMC had actual knowledge of Madoff's fraud. Nonetheless, based on the Trustee's investigation to date, JPMC failed to fully and accurately report Madoff's likely fraud to regulators despite obligations to do so. (*See, e.g*., Am. Compl. ¶¶ 574–78.)

The Trustee has alleged that, in making these misrepresentations, JPMC intended to deceive regulators. (Am. Compl. ¶ 577.) A plaintiff establishes a defendant's intent to deceive by alleging facts sufficient to support a strong inference of fraudulent intent. *See Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155, 171 (S.D.N.Y. 2009). Intent is established by alleging strong circumstantial evidence of conscious misbehavior or recklessness. *Id*. Courts have found recklessness to exist where a defendant failed to review or check information it had a duty to monitor or ignored obvious signs of fraud. *Novak*, 216 F.3d at 308. Recklessness has likewise been found when a defendant has received a cease and desist order from the SEC and thereafter promised to adopt the "gold standard" in its accounting practices, which it then failed to do. *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 219–20 (S.D.N.Y. 2004). In addition, when a defendant departs from generally accepted standards of practice, thereby overlooking red flags or other suspicious facts and circumstances, scienter has been adequately pled. *See, e.g., Silverman v. KPMG LLP* (*In re Allou Distrib., Inc*.) 395 B.R. 246, 284 (Bankr. E.D.N.Y. 2008).

Here, JPMC had a duty to monitor the 703 Account as well as review various materials provided by Madoff, the review of which showed glaring irregularities and indicated that Madoff was engaging in fraud. (*See*, *e.g.*, Am. Compl. ¶¶ 190–98, 203–10, 227–36.) Moreover, similar to *AOL Time Warner*, JPMC's duties were heightened in light of agreements entered into with regulators after their participation in the Enron fraud. (*See*, *e.g.*, *id.* ¶¶ 182–88.) These facts, coupled with JPMC's decision to ignore numerous red flags and internal policies amount to strong circumstantial evidence of JPMC's recklessness and conscious misbehavior.

2. The Trustee Has Sufficiently Alleged Reliance on JPMC's Misrepresentations

JPMC has also argued that the Trustee has failed to adequately plead reliance. (Def. Br. 59–60.) Contrary to JPMC's position, third party reliance is sufficient to satisfy the reliance element of this claim. In discussing the proximate cause element of a RICO fraud claim, the Supreme Court held that a cognizable injury need not always be committed directly against the plaintiff, recognizing "the long line of cases in which courts have permitted a plaintiff directly injured by a fraudulent misrepresentation to recover even though it was a third party, and not the plaintiff, who relied on defendant's misrepresentation." *Bridge v. Phoenix Bond & Indem. Co.*, 553 U.S. 639, 657 (2008). The Court observed that "the common law has long recognized that plaintiffs can recover in a variety of circumstances where, as here, their injuries result directly from the defendant's fraudulent misrepresentations to a third party." *Id.* at 653.

Third-party reliance has been held sufficient in numerous fraud cases under New York law. *See, e.g., Litvinov v. Hodson*, 905 N.Y.S.2d 400, 401 (4th Dep't 2010) (internal citations omitted); *see also Hyosung Am. Inc. v. Sumagh Textile Co., Ltd.*, 25 F. Supp. 2d 276, 283–84 (S.D.N.Y. 1998); *N.B. Garments* (*PVT.*) *Ltd. v. Kids Int'l Corp.*, No. 03 Civ. 8041, 2004 WL 444555, at *3 (S.D.N.Y. Mar. 10, 2004); *Wechsler v. Hoffman-La Roche, Inc.*, 99 N.Y.S.2d 588, 590 (Sup. Ct. 1950). *Cement & Concrete Workers Dist. Council Welfare Fund v. Lallo*, the case cited by JPMC that allegedly forecloses the use of third-party reliance, "conflicts with century old New York Court of Appeals cases, which, at the time that *Cement & Concrete Workers* was decided, and arguably still today, represent the law of New York." *N.B. Garments*, 2004 WL 444555, at *3 (citing *Eaton, Cole & Burntiam Co. v. Avery*, 83 N.Y. 31, 33–34 (1880)).

To establish third-party reliance, a plaintiff must assert the following: (1) a false representation made to a third-party; (2) the misrepresentation was relied upon to plaintiff's detriment; and (3) defendant intended the misrepresentation to be conveyed to plaintiff. *Trepel v. Dippold*, No.04 Civ. 8310(DLC), 2006 WL 3054336, at *5 (S.D.N.Y. Oct. 27, 2006) (internal citations omitted). Whether plaintiff justifiably relied on the misrepresentation or omission is a fact question that is not appropriate to decide at the dismissal stage. *Id.*; *see DDJ Mgmt., LLC v. Rhone Group L.L.C.*, 905 N.Y.S.2d 118, 122–23 (N.Y. 2010); *In re Allou*, 395 B.R. at 290.

As set forth in the Amended Complaint and summarized above, JPMC misrepresented information regarding Madoff and BLMIS as well as its own anti-money laundering polices to various federal and state regulators. (*See* Am. Compl. ¶¶ 217–47.) As a large bank that touted its standard of compliance, JPMC lent legitimacy and cover to Madoff which BLMIS customers relied upon to their detriment. (*Id.* ¶ 579.) Without the legitimacy and cover lent to Madoff by JPMC, BLMIS customers would not have been harmed to the extent they were. (*Id.* ¶¶ 579–82.)

3. The Trustee's Fraud on the Regulator Claim Is Not Preempted by Federal Banking Laws

The Trustee has alleged that JPMC defrauded state and federal regulators by submitting false information and failing to submit information when required to do so. (Am. Compl. ¶¶ 562–83.) Chase Bank has been regulated by both state and federal agencies. Chase Bank's predecessor was JPMorgan Chase Bank, New York, New York. (*Id.* ¶ 24.) As a New York state-chartered bank and a Federal Reserve member bank, JPMorgan Chase Bank, New York, New York was regulated by both the New York State Banking Department and the Federal Reserve. On October 13, 2004, the Office of the Comptroller of the Currency ("OCC") approved the bank's request to convert to a national banking association at which point JPMorgan Chase Bank, National Association came into existence. As a national banking association, Chase Bank is regulated by the OCC. As a Federal Reserve member bank until 2004 and, subsequently, a national bank, Chase Bank has at all relevant times been subject to the BSA.

Despite having been, at various times, regulated by both *state* and federal regulators (*Id.* ¶ 24), JPMC argues that fraud on regulators is preempted by federal banking laws. (Def. Br. 60–62.) Because the Trustee's fraud on the regulator claim is consistent with Congress's purpose in enacting and amending the Bank Secrecy Act ("BSA"), JPMC's preemption argument fails and the Trustee should be allowed to proceed with his claim.

a. Congress Enacted the Bank Secrecy Act to Require Banks to Assist Authorities in Identifying and Punishing Illegal Activities

The BSA was enacted in 1970 in response to a growing concern that domestic and foreign banks were being used to facilitate organized crime, and needed to report illegal activity. As Congress stated, "the purpose of this chapter is to require the maintenance of appropriate types of records and the making of appropriate reports by such businesses in the United States where such records or reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings." 12 U.S.C. § 1951(b). The BSA has been amended numerous times. In 1992, Congress passed the Annunzio-Wily Anti-Money Laundering Act, which added provisions authorizing the Secretary of the Treasury to issue regulations requiring financial institutions to maintain rigorous anti-money-laundering programs and file reports when faced with suspicious activity. 31 U.S.C. §§ 5314(g), (h).

JPMC argues that the Trustee's claim that JPMC submitted false information to the Federal Reserve and the OCC is preempted by the BSA because the claim conflicts with the policies underlying the BSA. (Def. Br. 60–62.) The opposite is true. The Trustee's common law fraud claims only further encourage banks like JPMC to provide accurate information to regulators.

b. Congress Did Not Intend to Preempt Common Law Fraud Claims When It Enacted the Bank Secrecy Act

In enacting the BSA, Congress did not, expressly or impliedly, preempt common law fraud claims. In determining the preemptive reach of a federal statute, "'[t]he purpose of Congress is the ultimate touchstone.'" *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996); *Cipollone*, 505 U.S. at 516. Congress's intent to preempt can be indicated either expressly—through the language of the statute—or impliedly through the structure or purpose of the statute. *Cipollone*, 505 U.S. at 516. Where there is no express statement, courts may infer preemptive intent where either "the scope of the statute indicates that Congress intended to federal law to occupy the legislative field, or if there is an actual conflict between state and federal law." *Altria*, 555 U.S. at 76–77; *Cipollone*, 505 U.S. at 516. A conflict exists "when it is impossible to comply with both state and federal law, . . . or where the state law stands as an obstacle to the accomplishment of the full purposes and objectives of Congress." *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 248 (1984).

The BSA neither expressly nor impliedly preempts the Trustee's fraud on the regulator claim. Rather, the claim is consistent with, and supportive of, Congress's goals in enacting the BSA.

(i) The Trustee's Fraud on the Regulator Claim Does Not Conflict with Any Policies Underlying the BSA

JPMC next argues that the Trustee's claim is impliedly preempted because it conflicts with Congress's purpose in enacting the BSA. (*See* Def. Br. 61–62.) On the contrary, a common law claim that punishes banks for submitting false information to regulators serves only to further the purposes of the BSA.

Moreover, establishing that state law is preempted as a result of a policy conflict is a high threshold. *Chamber of Commerce of the U.S. v. Whiting*, 131 S. Ct. 1968, 1983 (2011). Courts must look to an act's purpose to determine if allowing the state law claim would conflict with that purpose. *Altria*, 555 U.S. at 544. There is no conflict if the act's purpose is not furthered by limiting the state laws. *Id.*

The purpose of the BSA and Annunzio-Wily is to force banks to maintain complete records and to be diligent in identifying and reporting illegal activity. *See e.g.*, 31 U.S.C. § 5318(g), (h). Punishing JPMC for lying to federal regulators does not conflict with this goal but, rather, reinforces it. In addition, uniformity is not an issue with regard to state law fraud claims because there is a single, uniform standard for fraud claims: falsity. *See Cipollone*, 555 U.S. at 529; *Altria*, 555 U.S. at 544–45.

(ii) JPMC's Overreliance on *Buckman*

The weight of JPMC's argument rests on the Supreme Court's decision in *Buckman Co. v. Pls.' Legal Committee*, 531 U.S. 341 (2001). (Def. Br. 60–62.) However, *Buckman* is based on a different federal statute and thus is not controlling here.

Buckman involved a claim by individuals injured by orthopedic bone screws. 531 U.S. at 343. The plaintiffs' claim relied on the argument that, during the approval process for the devices, the defendant had misrepresented the intended use of the bone screws to the FDA. *Id.* at

346–47. In finding the claim to be preempted by the Food, Drug, and Cosmetics Act ("FDCA") and the Medical Devices Act ("MDA"), the Court relied on the fact that the plaintiffs' claim "conflict[ed] with the FDA's responsibility to police fraud consistently with the Administration's judgment and objectives." *Id.* at 350.

The *Buckman* Court then discussed ways in which the claim conflicted with federal policies. The court found that the plaintiffs' claim might deter applicants from submitting new devices for approval for fear that they would subject themselves to state law tort actions. *Id.* at 350–51. The Court also expressed concern regarding the "deluge of information" the FDA would receive from nervous applicants. *Id.* at 351. As the Court confirmed in a later decision, this interference was the basis of the court's decision. *See Whiting,* 131 S. Ct. at 1983 (plurality) (explaining that the law in *Buckman* conflicted with the FDA because it would have "directly interfered with the operation of the federal program" by burdening the FDA with additional filings).

The other cases JPMC cites are not persuasive because they address only the FDCA, the MDA, or statutes courts recognized as "similar to" those statutes, and involve claims that would have consequences similar to those relied upon in *Buckman. See Williams v. Dow Chem. Co.*, 255 F. Supp. 2d 219, 232 (S.D.N.Y. 2003) (preempted under the Federal Insecticide, Fungicide, and Rodenticide Act); *Timberlake v. Synthes Spine, Inc.*, No. V-08-4, 2011 WL 711075, at *8–9 (S.D. Tex. Feb. 18, 2011) (preemption under the MDA); *Riley v. Cordis Corp.*, 625 F. Supp. 2d 769, 785–88 (D. Minn. 2009) (preemption under the MDA).[18] Preemption, however, is a statute-specific inquiry. The policy considerations that served as the basis for the Court's analysis in *Buckman* do not apply to the BSA.

[18] The remaining cases cited by JPMC are irrelevant because the Trustee has stated a claim for fraud, not for violation of the BSA. (Def. Br. 62 n.11.)

The Trustee's claim that JPMC defrauded federal regulators does not provoke these same concerns. There is no potential downside to the public of subjecting banks to the requirement of truthfulness in their filings. As in *Whiting*, the fraud on the regulator claim would provide "further protection" against wrongful conduct and a "strong incentive" for the regulated parties to act appropriately. 131 S. Ct. at 1984. "The most rational path for" banks will be to comply with both laws. *Id.* Moreover, requiring banks to provide accurate information to regulators should not change the volume of information banks provide.

JPMC next argues that the Trustee's fraud on the regulator claim is preempted because the BSA, like the FDA, grants enforcement authority to federal agencies. (*See* Def. Br. 61–62.) This reading of *Buckman* is too broad. JPMC is effectively arguing that any federal statute that grants enforcement authority necessarily preempts any state statute that punishes similar conduct. This cannot be correct, as courts have repeatedly upheld claims for relief based on violations of a statute or regulation that includes governmental enforcement authority. *Lohr*, 518 U.S. at 495 (upholding claims based on violations of FDA regulations); *Drake*, 458 F.3d at 63–65 (upholding claims based on violations of the Federal Aviation Act); *Riegel v. Medtronic*, 451 F.3d 104, 124 (2d Cir. 2006) (upholding claims based on violations of the MDA).

As the Supreme Court has explained, it must be clear from the statute that Congress intended to give the federal agency exclusive authority to police deception. *See Altria*, 555 U.S. at 544 n.6. There is no statement in the BSA, as there is in the FDCA, that Congress specifically intended the OCC or the Federal Reserve to have exclusive enforcement authority.

(iii) JPMC's Argument Against Implying a Private Right of Action in New York State Law Is Misplaced

Finally, left without an argument that the Trustee's fraud on the regulator claim based on JPMC's misrepresentations to *state* regulators are preempted, JPMC argues that the claim is void because the state statutes do not provide for a private right of action. (Def. Br. 62–63.) As explained above, the Trustee is not bringing a claim under only state statutes—the Trustee is bringing a fraud clam based on JPMC's misrepresentations to regulators. (Am. Compl. ¶¶ 562–83.) The cases cited by JPMC stand only for the proposition that certain New York statutes do not contain a private right of action. (Def. Br. 63.) None of these cases undercuts the Trustee's claim for damages based on fraudulent information JPMC provided to state and federal regulators.

VII. THE TRANSFERS AND OBLIGATIONS ALLEGED IN THE COMPLAINT ARE AVOIDABLE

JPMC claims that $145 million in transfers it received from the 703 Account are not avoidable because: (1) they constituted repayment of two loans, one in the amount of $95 million made in November 2005, and the second in the amount of $50 million made in January 2006 (collectively the "Loans"); (2) JPMC was a secured creditor; (3) the Trustee has not pleaded the requisite level of intent on the part of JPMC to avoid the transfers; and (4) the repayment of the Loans amounted to a setoff and not a transfer. JPMC further argues that $590,000 in fees and $3.4 million in interest that it received from the 703 Account in connection with the Loans are also immune from avoidance for similar reasons.[19] None of JPMC's arguments have merit.

The Trustee's Amended Complaint alleges that JPMC knew or should have known that BLMIS was engaged in a fraud or was insolvent at each of the times JPMC: (1) charged BLMIS fees; (2) extended credit to BLMIS and purported to retain a security interest in bonds held by

[19] Although the Amended Complaint alleges additional transfers, JPMC has brought this motion only as to the direct transfers from BLMIS of a purported security interest in the bonds, $145 million in loan repayments, interest on the loans and the account fees (the "Transfers"). (Def. Br. 67 n.15.) (*See also* Am. Compl. ¶ 306).

BLMIS; and (3) accepted repayment of the Loans and associated interest out of the 703 Account. The Trustee also alleges that BLMIS, through Madoff, directed the Transfers to JPMC in furtherance of his Ponzi scheme, and these Transfers were actually and constructively fraudulent. Thus, the Loans could not have created a *valid* antecedent debt when JPMC knew or should have known that such obligations were incurred, and Transfers made, in furtherance of a fraudulent scheme. The Trustee's allegations more than establish that the relevant Transfers were made, and related obligations incurred, by BLMIS with actual fraudulent intent, and that BLMIS did not receive fair consideration for these also constructively fraudulent Transfers and obligations. JPMC's attempt to raise its affirmation defenses now as to whether it can rebut the Trustee's allegations is inappropriate on a motion to dismiss.

JPMC cannot show the existence of a valid antecedent debt by summarily asserting that at one time it had a security interest in the bonds, particularly when at all relevant times it knew or should have known that the Loans purportedly secured by the bonds were being used to enable a fraud. Nor may JPMC escape liability by contending that Transfers it received from BLMIS were payment for purported services rendered to BLMIS, when JPMC knew or should have known such "services" were in furtherance of a fraud. As the Trustee alleges in the Amended Complaint, any purported liens transferred to JPMC from BLMIS to ostensibly secure obligations incurred at a time when JPMC knew or should have known that BLMIS was engaged in fraud or insolvent, are avoidable. (Am. Compl. ¶ 299.) Accordingly, not only are the Transfers and obligations avoidable, but so too are liens (if any) held by JPMC associated with the Loans. Crucial issues as to JPMC's lack of good faith and whether BLMIS received fair consideration for the underlying obligations and Transfers of necessity requires factual determinations that are premature and inappropriate on a motion to dismiss.

As to JPMC's remaining arguments, they are unsupported by facts or law. As a preliminary matter, the Trustee has alleged that repayment of the Loans constituted a transfer. Therefore, JPMC's assertion of a "setoff" is an affirmative defense, not appropriate on a motion to dismiss. Moreover, JPMC's argument is specious because no setoff occurred here. Rather, Madoff directed that the Loans be satisfied by a direct transfer to JPMC of funds from the 703 Account, which consisted of primarily customer property.[20] This re-payment constitutes a transfer from BLMIS to JPMC and not a setoff of mutual obligations. Similarly, any amounts received by JPMC from the 703 Account on account of interest or fees constitute transfers by BLMIS to JPMC rather than a setoff of mutual obligations. In any event, no setoff could have occurred here because JPMC knew that the funds in the 703 Account belonged to BLMIS's customers. Even if JPMC had any argument supporting a right to setoff, this would require a factual determination into the equities and mechanics of the transactions and is, thus, not proper on a motion to dismiss.

Following full discovery by all parties, at trial, JPMC can attempt to prove that the Trustee's allegations in the Amended Complaint are false. In connection with the present motion, however, the Trustee's allegations must be taken as true and all inferences must be viewed in the light most favorable to the Trustee. Because the Trustee has more than met his pleading burden at this stage in the proceeding, the Amended Complaint must stand.

[20] By operation of SIPA, customer property is deemed debtor property as of the commencement of the SIPA proceeding and thus subject to avoidance actions. *See* SIPA §§ 78fff-2(c)(3), 78lll(4).

A. The Amended Complaint Alleges That JPMC Knew or Should Have Known That Madoff Was Engaged in Fraud or Insolvent at the Time It Extended Credit To, Received Payments From, and Performed Services for BLMIS

In exchange for providing the Loans to BLMIS, JPMC claims that it obtained a security interest in bonds purportedly held by BLMIS that, according to JPMC, BLMIS had received "free" from a customer. (*See* Am. Compl. ¶¶ 279–86.) JPMC also collected more than $3.4 million in interest on the Loans. (*Id*. ¶ 288.) In June 2006, Madoff directed JPMC to transfer the $145 million in principal amount of the Loans from the 703 Account to JPMC in repayment of the Loans, thereby depleting Customer Property in the 703 Account. (*Id*.) Madoff directed the repayment of the loans to JPMC, and JPMC received this repayment knowing the funds in the 703 Account belonged to BLMIS's customers and were being held for their benefit.

At all relevant times—including when JPMC extended, collected interest on, and accepted repayment of the Loans—JPMC knew or should have known that Madoff was engaged in fraud or was insolvent and that the Loans were in furtherance of that fraud. At a minimum, JPMC had been aware of fraudulent activity in the 703 Account since at least the 1990s and extended credit with knowledge of fraud at BLMIS and without conducting any further inquiry into BLMIS's solvency or activities. (*See* Am. Compl. ¶¶ 278-95 & ¶ 303.) Moreover, JPMC knew at the time it extended credit to BLMIS that the funds in the 703 Account consisted of Customer Property. (*See, e.g.*, Am. Compl. ¶¶ 2, 190, 192, 200, 244, 247, 259 & 291.) Accordingly, JPMC also knew that if the Loans were satisfied from the 703 Account, such repayment would come from customer property.

B. The Trustee Has Sufficiently Alleged Avoidance Claims Based on Actual Fraud, as to Which JPMC's Intent Is Irrelevant

Only Madoff's intent is relevant to the sufficiency of the Trustee's allegations in connection with his avoidance claims based on actual fraud. JPMC may seek to defend against these claims by trying to prove that it provided the Loans and received the Transfers in good faith. *Picard v. Cohmad Sec. Corp.* (*In re Bernard L. Madoff Inv. Sec. LLC*), 2011 WL 3274077, at *9 (Bankr. S.D.N.Y. Aug. 1, 2011); *see also Orozco-Prada*, 636 F. Supp. 1537, 1541 (S.D.N.Y. 1986). However, under both the New York Debtor & Creditor Law and the Bankruptcy Code, it is JPMC's burden to prove its good faith as an affirmative defense.

Section 276 of the New York Debtor & Creditor Law, made applicable pursuant to § 544(b) of the Bankruptcy Code, provides:

> Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.

N.Y. DEBT. & CRED. LAW § 276. Similarly, § 548 of the Bankruptcy Code provides that the Trustee may avoid any transfer or incurrence of an obligation within two years prior to the Filing Date, if the debtor made such transfer or incurred such obligation with intent to hinder, delay or defraud present or future creditors. *See* 11 U.S.C. § 548(a)(1)(A) (2011). Because BLMIS was a Ponzi scheme, BLMIS's actual fraudulent intent has been established as a matter of law for purposes of both the Bankruptcy Code and the New York Debtor & Creditor Law. *See Gowan v. Wachovia Bank, N.A. (In re Dreier LLP)*, 2011 WL 3319711, at *8 (Bankr. S.D.N.Y. Aug. 3, 2011); *Picard v. Merkin (In re Bernard L. Madoff Inv. Secs. LLC)*, 440 B.R. 243, 255, 257 (Bankr. S.D.N.Y. 2010).

Defendants argue that the Trustee's intentional fraudulent conveyance counts under New York state law should be dismissed because New York law requires fraudulent intent on the *transferee's* part to sustain a claim under section 276. (Def. Br. 73.) Defendants are wrong. Numerous recent cases have confirmed that transferee intent is not required to avoid and recover a fraudulent transfer under § 276 of the New York Debtor & Creditor Law. *See Picard v. Merkin (In re Bernard L. Madoff Inv. Secs LLC*), Slip Op. No. 11-MC-00012 (KMW) (S.D.N.Y. Aug.

31, 2011) ("*Merkin II*") at 11–12; *Gowan v. Patriot Group, LLC (In re Dreier LLP)*, 2011 WL 2412581, at *3 (Bankr. S.D.N.Y. June 16, 2011) (Glenn, J.); *Gowan v. Wachovia*, 2011 WL 3319711, at *8 (same) (Bernstein, J.); *Picard v. Cohmad*, 2011 WL 3274077, at *9; *Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 56 (2d Cir. 2005) (acknowledging that to prove actual fraud under § 276, the creditor must show intent to defraud on the part of the transferor only) (citing *HBE Leasing Corp. v. Frank*, 61 F.3d 1054, 1059 n.5 (2d Cir. 1995)).

Moreover, the plain language of § 276 establishes that the relevant intent is that of the *transferor*, and not the transferee. *See Merkin II* at 12; *Gowan v. Patriot*, 2011 WL 2412581, at *30–32 (same; discussing origin of confusion concerning need for transferee intent). JPMC thus relies on a line of cases that is not good law. (Def. Br. 73); *see Gowan v. Patriot*, 2011 WL 2412581, at *31–32.

Similarly misguided is JPMC's reliance on § 278(2) of the New York Debtor & Creditor Law. That statute provides an affirmative defense to a good faith transferee. Here, the Trustee's Amended Complaint is rife with allegations that JPMC knew or should have known of fraudulent activity at BLMIS and assisted Madoff in prolonging and expanding the fraud to the detriment of BLMIS customers. As courts have recognized, rather than supporting JPMC's position, the existence of the 278 defense is further evidence that the transferee's intent need not be pleaded by the Trustee:

> Further support for [the] proposition [that transferee intent is not needed] is gleaned from section 278, which provides an affirmative defense to a bona fide purchaser for value without knowledge of the fraud to retain the transfer. *See* N.Y. DEBT. & CRED. LAW § 278(2). As an affirmative defense, section 278 requires that the transferee's intent be considered "at the summary judgment phase or at trial on a full evidentiary record." (citation omitted) Therefore, "[i]f the Trustee meets the evidentiary burden of proving a prima facie case of actual fraud . . . the burden shifts to the transferee to establish the affirmative defense. . . ."

> (citation omitted) Accordingly, a defendant's good faith "need not be negated by the Trustee in the Complaint."

Picard v. Cohmad, 2011 WL 3274077, at *9 (quoting *Gowan v. Patriot*, 2011 WL 2412581, at *33; citing *SIPC v. Stratton Oakmont, Inc.*, 234 B.R. 293, 318 (Bankr. S.D.N.Y. 1999)). "On a motion to dismiss, the trustee only needs to allege a prima facie case of actual fraud." *Gowan v. Patriot*, 2011 WL 2412581, at *33. "[B]ecause section 278 is an affirmative defense, the transferee's intent should be considered on a full evidentiary record, either at the summary judgment phase or at trial." *Merkin II* at 12 (*citing Gowan v. Patriot*, 2011 WL 2412581, at *33). Similarly, under the Bankruptcy Code, § 548(c) is an affirmative defense that must be proven by the defendant in the face of the Trustee's fraud claims pleaded under § 548(a), which does not require transferee intent. *See id.* at *26. "The Trustee is not, however, required to dispute the elements of the [defendants'] good faith affirmative defense in order to survive a motion to dismiss." *Merkin II* at 17-18.

In any event, even if transferee intent were ultimately required, it is alleged in the Amended Complaint. Where multiple badges of fraud are demonstrated, actual fraud can be found. *See Christian Bros. High Sch. Endowment v. Bayou Leverage Fund, LLC (In re Bayou Group, LLC)*, 439 B.R. 284, 304 (S.D.N.Y. 2010) (redemptions reflecting multiple badges of fraud demonstrated actual fraudulent intent); *see also Kaiser v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582 (2d Cir. 1983). A transferee's intent may be established through badges of fraud, which include such considerations as "the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt" and "the general chronology of the events and transactions under inquiry," *In re Kaiser*, 722 F.2d at 1582–83, or may be "inferred from the circumstances surrounding the transaction, including the relationship among the parties" and the "unusualness of the transaction," *HBE Leasing Corp.*, 48 F.3d at 623, 639. A trustee also can establish a strong inference of fraud with facts showing a "motive and opportunity to commit fraud" or "circumstantial evidence of conscious misbehavior or recklessness." *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *see also Picard v. Merkin*, 440 B.R. at 258.

As stated above, the Trustee has alleged that JPMC had actual knowledge of, and participated and assisted in, Madoff's fraud. This meets any standard of transferee intent relevant to avoidance actions. And it far surpasses the standard necessary to plead a lack of fair consideration for constructively fraudulent transfers, which, as discussed below, is the only standard as to which JPMC's knowledge or intent is relevant at this point. *See HBE Leasing Corp.*, 48 F.3d at 636–37, 639.

C. The Trustee has Sufficiently Alleged Claims Based on Constructive Fraud

The Trustee has also asserted constructive fraud claims under §§ 273-275 of the New York Debtor & Creditor Law. To state a claim for constructive fraud, the Trustee must allege as an element that an obligation was undertaken or a transfer made by the debtor without "fair consideration." Fair consideration under New York law has two parts: (1) fair equivalent value; and (2) good faith. *Gowan v. Patriot*, 2011 WL 2412581, at *39. Here, the Trustee has alleged, *inter alia*, that when JPMC made the Loans to BLMIS and received Transfers from it, these transactions did not provide BLMIS with fair consideration because JPMC knew or should have known at all relevant times that such transactions were in furtherance of a fraud rather than any legitimate business purpose. JPMC, therefore, lacked good faith in connection with the Loans and the Transfers. In addition, as alleged, JPMC infused BLMIS with cash at a time when the Ponzi scheme was at risk of collapsing, thus providing liquidity to continue the Ponzi scheme. JPMC, therefore, did not provide fair equivalent value where it assisted BLMIS to prop up the fraud at a time when it knew or should have known of fraudulent activity.

The good faith element for an affirmative defense under § 548(c) of the Bankruptcy Code and § 278 of the New York Debtor & Creditor Law, discussed below, requires only that an objective standard is met. *See Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.),* 247 B.R. 51, 114, 116 (Bankr. S.D.N.Y. 1999) ("The two statutes devolve from the same source, are founded on the same principles and are designed to effectuate the same purposes."). Under § 272 of the New York Debtor & Creditor Law, "[w]here [] a transferee has given equivalent value in exchange for the debtor's property, the statutory requirement of 'good faith' is satisfied if the transferee acted *without either actual or constructive knowledge* of any fraudulent scheme." *HBE Leasing Corp.*, 48 F.3d at 636 (emphasis added). Similarly, it is well-settled law that the good faith defense under § 548(c) of the Bankruptcy Code involves a two-step objective inquiry: "(1) whether [the transferee] was on inquiry notice of the [debtor's] fraud and (2) whether the [transferee] was diligent in its investigation of the [debtor]." *Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)* ("*In re Manhattan I*"), 397 B.R. 1, 23 (S.D.N.Y. 2007); *In re Bayou Group, LLC*, 439 B.R. at 310–12; *Gowan v. Wachovia*, 2011 WL 3319711, at *10.

Under the New York Debtor & Creditor Law, a transferee does not need to have actual knowledge of the scheme that causes the conveyance to be fraudulent, rather "[c]onstructive knowledge of fraudulent schemes will be attributed to transferees who were aware of circumstances that should have led them to inquire further into the circumstances of the transaction, but who failed to make such inquiry." *HBE Leasing Corp.*, 48 F.3d at 636. JPMC cites to *In re Agape Litigation* for the proposition that the Trustee must show that JPMC had actual knowledge of Madoff's fraud. (Def. Br. 75.) That case, however, only involved *tort claims* for aiding and abetting conversion, fraud, and breach of fiduciary duty, and not avoidance of transfers under either the Bankruptcy Code or the New York Debtor & Creditor Law. *See generally In re Agape Litig.*, 773 F. Supp. 2d at 302.

Here, the Amended Complaint alleges sufficient facts to bring common law claims for damages based on participating in and aiding and abetting a fraud. These facts more than meet the lower standard for constructive knowledge, which requires only a demonstration of JPMC's failure to conduct a "reasonable" inquiry into suspicious circumstances, and conclusively defeat any good faith defense. *See United States v. Orozco-Prada*, 636 F. Supp. at 1537, 1543 (S.D.N.Y. 1986); *Interpool Ltd. v. Patterson*, 890 F. Supp. 259, 268 (S.D.N.Y. 1995).

JPMC's argument that constructively fraudulent transfers require a finding that JPMC possessed a "subjective" mental state akin to "actual knowledge" is wrong. (Def. Br. 75.) In support, JPMC quotes *HBE Leasing* as applying a higher, subjective intent standard. *HBE Leasing Corp.*, 48 F.3d at 637. However, the Second Circuit in *HBE Leasing Corp.*, which concerned whether to collapse a series of separate transactions to determine whether a constructively fraudulent transfer occurred, did not find that a higher, subjective intent standard must be applied in such transactions. *Id.* at 636–37. The Court held that the relevant legal standard was constructive knowledge, and stated that "constructive knowledge will be attributed to one who is aware of circumstances that should have led them to inquire further into the circumstances of the transaction, but who failed to make such inquiry." *Id.* at 636. *See also Gowan v. Patriot*, 2011 WL 2412581, at *43–44. While the court recognized that "there is some ambiguity as to the precise test for constructive knowledge" as between a "reasonable inquiry" or a "conscious turning away" standard, *HBE Leasing Corp.*, 48 F.3d at 636–637, it found that under the circumstances of that case, the defendant's failure to conduct "reasonable inquiry" when on notice of facts that "should have" put it on notice of the improper transfer *constituted* a "conscious turning away," and was sufficient to charge her with constructive knowledge *Id.* at 673.

The only other support offered by JPMC for its "akin to actual knowledge" standard is a reference to dicta in *CFTC v. Walsh*, 618 F.3d 218, 230 (2d Cir. 2010), that under § 272 "the focus of the good faith inquiry is the subjective intent of the transferee." That statement was made in the context of certifying a question to the New York Court of Appeals as to whether a spouse who in good faith relinquished a claim to proceeds of a fraud had provided fair consideration; there was "no reason to question [the transferee's] good faith" and no further analysis of the issue. *Id.* at 230–231. And the cases cited by the court in that case applied an objective "reasonable inquiry" standard in determining good faith. *Id.* at 230. JPMC's attempt to rely on this statement to contradict the black letter law of constructive knowledge is mistaken.

Again, however, under any possible standard up to and including actual knowledge of a fraud, the Trustee has met his pleading burden by alleging JPMC's actual knowledge of, and assistance to Madoff, in connection with the fraud.

The Trustee has also alleged that JPMC did not provide fair equivalent value to BLMIS because at or about the time that BLMIS entered into the Loans, the Ponzi scheme was at risk of collapsing, and the proceeds from the Loans provided liquidity to continue the Ponzi scheme through the 703 Account, at a time that JPMC had knowledge of fraud at BLMIS. (*See* Am. Compl. ¶ 300.) At a minimum, the determination of consideration and "reasonably equivalent value" is a fact question that cannot be decided on a motion to dismiss. *Klein v. Tabatchnik*, 610 F.2d 1043, 1047 (2d Cir. 1979) (explaining that "[f]airness of consideration is generally a question of fact"); *Lipshie v. Wise (In re Wise)*, 119 B.R. 392, 394 (E.D.N.Y. 1990); *see also United States v. McCombs*, 30 F.3d 310, 326 (2d Cir. 1993).

D. JPMC was on Notice of Fraud at all Relevant Times Including at the Time of the Loans and the Transfers, and Cannot Demonstrate a Valid Antecedent Debt

The Trustee has alleged that, at the time JPMC made the Loans to BLMIS, JPMC knew or should have known that Madoff was engaged in fraud or was insolvent. (Am. Compl. ¶ 299.) JPMC therefore did not act in good faith at the time that BLMIS incurred its obligations to JPMC in connection with the Loans. Because such obligations are avoidable as both actually and constructively fraudulent, the subsequent repayment of those Loans was not on account of a *valid* antecedent debt and is also subject to avoidance and recovery by the Trustee.

Sharp Int'l Corp. v. State Street Bank and Trust Co. (*In re Sharp Int'l Corp.*), 403 F.3d 43 (2d Cir. 2005), on which JPMC relies, is inapposite. In *Sharp*, the defendant-bank loaned money to the debtor in 1996, and there was no allegation that the bank knew or should have known at that time that the debtor was engaged in fraudulent activity or was insolvent. *In re Sharp Int'l Corp.*, 403 F.3d at 47. Indeed, the loan appeared to have been made *before* the fraudulent activity itself. *Id*. at 46-47. At some later point, the bank became suspicious of fraud and demanded that its prior loan be repaid. *Id.* at 47. To satisfy the bank, the debtor approached a number of noteholders to solicit new investments. *Id.* at 48. In affirming the dismissal of the constructive fraudulent conveyance claims brought under New York law and by the trustee against the bank, the Second Circuit held that the plaintiff failed to adequately allege a lack of fair consideration. *Id.* at 57. In fact, the trustee in *In re Sharp* conceded that repayment of the loan was on account of a valid antecedent debt and, therefore, was made for fair equivalent value. *Id.* at 54-55.

Sharp has no relevance to the Trustee's avoidance claims based on actual fraud, because in *Sharp* such claims had not been adequately pleaded. *Id.* at 56. As to the Trustee's constructive fraud claims, JPMC argues that the *Sharp* court substituted an "active participation" standard for *HBE Leasing*'s "constructive knowledge" standard, because it held that the trustee in that case had failed to demonstrate the defendant bank's participation in the fraud. (Def. Br. 71–72.) But *Sharp* did not overrule or replace the constructive knowledge standard articulated in *HBE Leasing*; rather, it found that the constructive knowledge standard articulated in *HBE Leasin*g, "had no applicability" to the case before it, where the loan had been "made in good faith long before the purportedly fraudulent transfer." *Id.* at 55; *see Merkin II* at 22-23 (rejecting defendants' argument that *Sharp* requires showing of transferee participation in all constructive fraud cases under New York law; the Trustee's "allegations of knowledge of the fraud at the time of investment remove the instant matter from the purview of the rule articulated in *Sharp.*")

The critical factor in *Sharp* was whether good faith existed at the time the debt was incurred. *See In re Sharp Int'l Corp.*, 403 F.3d at 55; *see also Merkin II* at 22; *Silverman v. Actrade Capital, Inc. (In re Actrade Fin. Tech. Ltd.),* 337 B.R. 791, 805-06 (Bankr. S.D.N.Y. 2005). In *In re Actrade,* the debtor, Allou, and its principals obtained financing from Actrade, secured by fictitious sales of inventory that the debtor never purchased. *In re Actrade Fin. Tech. Ltd.*, 337 B.R. at 797–98. The trustee for Allou alleged that Actrade knew or should have known that the sales were fictitious and claimed that Actrade advanced funds against fictitious inventory and assisted in concealing Allou's fraud from its creditors. *Id.* at 798. The court held that the trustee's pleadings adequately stated a claim for constructive fraudulent conveyance sufficient to overcome a motion to dismiss where the complaint alleged that "Actrade had 'actual or constructive knowledge of [a] fraudulent scheme' *in connection with the incurrence of the debt*." *Id.* at 806 (emphasis added) (quoting *Miller v. Forge Mench P'ship Ltd.*, 2005 WL 267551, at *6 (S.D.N.Y. Feb. 2, 2005)). As in *In re Actrade* and as detailed above, the Trustee here has alleged facts showing that JPMC knew or should have known at the time that it extended credit to BLMIS that it was engaged in a fraud or that BLMIS was insolvent.

Gowan v. Wachovia, 2011 WL 3319711, at *10, is instructive. There, the court distinguished circumstances such as those present here from the facts before it, in which the obligations incurred by the debtor were found not to be avoidable. In dismissing the trustee's claims against the defendant-bank, Judge Bernstein observed that the bank there "did not invest in the Ponzi scheme and did not maintain the account through which [the fraudster] ran it." *Id.* at *5. To defendant Wachovia, the court found, Dreier LLP appeared legitimate, and because Wachovia was not the primary bank from which the Ponzi scheme was run, the inflows and outflows of funds connected with "the Ponzi scheme transactions would not have come to Wachovia's attention or sounded any alarms." *Id.*

Here, in addition to being a financer of and indirect investor in Madoff's Ponzi scheme through feeder funds, and in addition to the Trustee's other allegations showing JPMC's lack of good faith (*see* Am. Compl. ¶¶ 278-295, 303 and 315), the Ponzi was operated from the 703 Account at JPMC. Contrary to JPMC's arguments, it was at the center of Madoff's fraud and cannot characterize itself as an innocent bank, an innocent investor with BLMIS or equivalent to an ordinary course landlord or trade creditor that provided legitimate services to BLMIS.

Moreover, in connection with repayments of the Loans, BLMIS did not receive fair consideration. To the contrary, because the credit it provided to BLMIS was—as JPMC knew or should have known—fuel that fed Madoff's scheme, JPMC has no defenses to the Trustee's fraudulent transfer claims. *See Merkin II* at 22-23; *see also In re Actrade Fin. Tech. Ltd.*, 337 B.R. at 806 (focusing on the defendant's constructive or actual knowledge "*in connection with the incurrence of the debt*") (emphasis added). In analogous circumstances, courts have held that only innocent investors who reasonably believed that they were investing in a legitimate business are validly entitled to claims for principal. *See, e.g., Picard v. Merkin*, 440 B.R. at 262; *Picard v. Chais (In re Bernard L. Madoff Inc. Secs. LLC)*, 445 B.R. 206, 225-26 (Bankr. S.D.N.Y. 2011); *Donell v. Kowell*, 533 F.3d 762, 772 (9th Cir. 2008); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 596 n.7 (9th Cir. 1991).

JPMC also argues that the interest and fees earned on the Loans are not avoidable, relying upon *In re Unified Commercial Capital* and *In re Carrozzella & Richardson*. (*See* Def. Br. 72.) But those cases reinforce the conclusion that a party with constructive or actual knowledge of a Ponzi scheme, such as JPMC, cannot benefit from that scheme. *See In re Unified Commercial Capital*, 2002 WL 32500567, at *1 (W.D.N.Y. June 21, 2002) (recognizing a remedy for fraudulent transfers in circumstances where the creditor "had knowledge of the fact that [the debtor] was engaged in a Ponzi scheme, and that the source of [the creditor's] interest payments was the funds of other, innocent investors who stood to lose their money when the scheme collapsed"); *In re Carrozzella & Richardson*, 286 B.R. 480, 491 (D. Conn. 2002) ("there is no to suggestion in the record that Defendants were anything but innocent investors. . . . [or] that they were aware that the Debtor was operating a Ponzi scheme. This was not the typical 'too-good-to-be-true' investment scheme."); *see also In re Churchill Mortgage Investment Corp.*, 256 B.R. 664, 673-674 (Bankr. S.D.N.Y. 2000) (recovery of commissions improper when trustee did not allege that brokers had any knowledge of scheme, or that brokers' activities were fraudulent, unlawful, or wrongful in any manner). As a party with unclean hands, JPMC may not be permitted to benefit from the receipt of interest and fees as a participant in the fraud. *See Gibbs & Sterret Mfg. Co. v. Brucker*, 111 U.S. 597, 601 (1884) ("[O]ne who has himself participated in a violation of the law cannot be permitted to assert in a court of justice any right founded upon or growing out of the illegal transaction.”).

E. JPMC’s Lack of Good Faith Negates Any Argument That a Security Interest, Even Assuming One Existed, Could Not Diminish the Value of BLMIS’s Assets

Assuming *arguendo* that JPMC had a security interest in connection with the Loans, the purported transfer of that security interest would be avoidable for the same reasons that the Loans are avoidable. A fraudulent conveyance under New York law includes the creation of a lien or encumbrance. *See* N.Y. Debt. & Cred. Law § 270. There is no rule immunizing transfers or obligations from avoidance because they relate to “secured” loans; to the contrary, the analysis remains whether a transfer—of a security interest or cash—or an obligation, like a loan, was undertaken for value and in good faith. *See, e.g., Gowan v. Wachovia Bank*, 2011 WL 3319711, at *9 (“If the obligation is avoided as fraudulent, the lien is unsupported by consideration.”); *Atlanta Shipping Corp., Inc. v. Chem. Bank*, 631 F. Supp. 335, 347 (S.D.N.Y. 1986); *In Matter of Tuller’s, Inc.*, 480 F.2d 49, 52 (2d Cir. 1973); *Chemtex LLC v. St. Anthony Enters., Inc.*, 490 F. Supp. 2d 536, 545 (S.D.N.Y. 2007); *United Orient Bank v. Capital Testing Corp.*, 221 A.D.2d 257, 258 (N.Y. App. Div. 1st Dep’t 1995); *Hyde v. Wolf*, 31 A.D. 125, 126–27 (N.Y. App. Div. 1st Dep’t 1898).

To be clear, no matter how the payments to JPMC are characterized, the transactions at issue harmed the estate and its creditors because they were deprived of a $145 million asset, which instead was transferred to JPMC. The $145 million in funds transferred to JPMC otherwise would have been available to creditors had BLMIS not authorized the payment from the 703 Account to satisfy the Loans, which were invalid obligations. Moreover, at a time when JPMC knew or should have known of the fraud, it extended credit to BLMIS, providing further liquidity to the Ponzi scheme, allowing it to last longer and, ultimately, harming its creditors.

Just as with other transfers, in cases where the transfer is a security interest, "*what constitutes fair consideration is a question of fact* to be determined upon the facts and circumstances of the particular case." *Gelbard v. Esses*, 96 A.D.2d 573, 576 (N.Y. App. Div. 2d Dep't 1983) (emphasis added) (quotation omitted). JPMC's reliance in *Lippe v. Bairnco Corp.* is unfounded. In *Lippe*, the lack of good faith was not alleged against any of the parties. Thus, a "reasonable jury could only find the transactions were legitimate."[21] *Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 360 (S.D.N.Y. 2003). And *Bear, Stearns Sec. Corp. v. Gredd* (*In re Manhattan Inv. Fund Ltd.*) ("*In re Manhattan II*"), 275 B.R. 190, 193–94 (S.D.N.Y. 2002) is equally inapposite because it concerned transfers of funds that remained in control of the defendant and not the debtor pursuant to federal securities laws. The court agreed that under federal securities laws, the funds were not property of the estate. *Id.* at 198.

F. JPMC's Setoff Argument is Inapplicable

1. There Was No Setoff Here

JPMC argues that when it received $145 million from the 703 Account, it was merely exercising its right of setoff and not receiving a transfer. JPMC is wrong both factually and legally.

As a threshold matter, no setoff occurred here. Moreover, the assertion of a setoff is an affirmative defense not appropriate for adjudication on a motion to dismiss. Whether or not

[21] All of the cases that JPMC relies upon are inapposite. Either there was no finding of lack of good faith on the part of the relevant parties, the transactions at issue were unrelated to a fraud, or the transfers were made on account of a *valid* antecedent debt. *See generally Miller v. Forge Mench P'ship, Ltd.*, 2005 WL 267551, at *6 (S.D.N.Y. Feb. 2, 2005); *Bear, Stearns Secs. Corp. v. Gredd* (*In re Manhattan Inv. Fund Ltd.*), 275 B.R. 190, 195–99 (S.D.N.Y. 2002); *Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 360 (S.D.N.Y. 2003); *Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortg. Co.)*, 471 F.3d 977, 1008–09 (9th Cir. 2006); *Melamed v. Lake Cnty. Nat'l Bank*, 727 F.2d 1399, 1402 (6th Cir. 1984); *In re Nat'l Century Fin. Enters., Inc.*, 2011 WL 1397813, at *23 (S.D. Ohio Apr. 12, 2011).

JPMC's loan to BLMIS constituted a valid debt, Madoff voluntarily directed repayment of the loan by instructing JPMC to transfer the funds from the 703 Account. (*See* Am. Compl. at ¶ 288.) It is long established that New York courts have recognized the fundamental distinction between a voluntary payment and a setoff. *See, e.g., In re Gen. Assign. for the Benefit of Creditors of Tiffany Lingerie, Inc.*, 208 N.Y.S.2d 471, 476 (Sup. Ct. Kings. County 1960) (the setoff required a "'distinct demand[']" and "what was in its origin a set-off ma[y] by agreement bec[o]me a payment.'") (quoting *Benham v. Columbia Canal Co.*, 132 P. 884, 887 (Wash. 1913)); *Am. Metal Co. v. M/V Belleville*, 284 F. Supp. 1002, 1007 (S.D.N.Y. 1968) (distinguishing voluntary payments from setoffs); *Morton v. Ludlow*, 6 N.Y. Ch. Ann. 275 (N.Y. Ch. Ct. 1833) ("Where a party claims a set-off and yet settles the debt without further steps to establish his right, this amounts to a voluntary payment.").

Moreover, a setoff can take place only after a debt has matured. *See Fenton v. Ives*, 222 A.D.2d 776, 777-78 (3d Dep't 1995) ("In exercising its right of setoff, a bank may only setoff against matured debts . . . ."). To exercise its right of setoff, a bank must wait until the day after maturity of the debt to set off the indebtedness and must give the debtor notice of the setoff. *See Marine Midland Bank-New York v. Graybar Elec. Co., Inc.*, 363 N.E.2d 1139, 1143 (N.Y. 1977) (bank acted prematurely where the setoff was made on the due date of the loan; the right of setoff could be exercised the day after maturity); N.Y. BANKING LAW § 9-g(2) ("No banking institution shall . . . exercise any right of set off . . . unless, prior to or on the same business day of such action, notice of the set off together with the reasons for the set off are mailed to the depositor.").

Here, the record thus far contains no note, loan agreement, security agreement nor any evidence of any demand made on BLMIS and/or Madoff to repay the Loans, or information as to when the Loans matured, both of which would be necessary but not sufficient steps to effect a valid setoff. Rather, as alleged in the Amended Complaint, Madoff directed repayment of the Loans, just as he directed the other payments and Transfers at issue in this case, apparently before the Loans had matured. The repayment at issue here was a voluntary payment by BLMIS and/or Madoff to JPMC and thus a "transfer" for purposes of the avoidance laws. *See, e.g., Steiner v. Mutual Alliance Trust Co. of New York*, 139 A.D. 645, 646 (1st Dep't 1910) ("If the maker of the notes consented that they be charged to his account before they were due, that was a payment of them.").

2. JPMC Could Not Use the 703 Account for Setoff Because It Knew The Funds in the Account Belonged to BLMIS's Customers

In addition to being factually inapplicable, the doctrine of setoff is unavailable to JPMC as a matter of law. It is black-letter law that a bank may not set off using deposited funds when the bank knows that the deposited money is held by the depositor for the use of another:

> [A] set-off by a bank is generally improper where the money deposited does not belong to the depositor, at least where the bank has knowledge that the moneys are held by the depositor for the use of another, as in the case of an agent, factors, or *broker*, or a public official, *or where the bank has notice of the third party's interest*, or where the bank has knowledge of facts sufficient to put it on inquiry as to ownership by one other than the depositor.

9 C.J.S. *Banks* § 320 (2011) (emphasis added) (citations omitted). Regardless of whether the 703 Account was characterized as a "special" account or a "general" account, JPMC was well aware at all relevant times that the funds in that account constituted Customer Property. (*See, e.g.*, Am. Compl. ¶¶ 2, 190, 192, 200, 244, 247, 259, 291.) For example, the Trustee has alleged that as BLMIS's banker, JPMC accepted BLMIS customers' funds for deposit into the 703 Account—including funds belonging to its own private bank customers—and approved wire transfers originating in the account. (*Id.* ¶¶ 191, 196, 202, 504, 503.) Indeed, JPMC honored

customer checks for deposit into the 703 Account, seeing firsthand customer money credited to the account. (*Id.* ¶ 196.)

"It is universally conceded that knowledge upon the part of a bank that deposits made by a debtor of the bank in his own name belonging to a third person absolutely precludes the bank from applying such funds to the individual indebtedness of the depositor to it." *Schreibman v. Chase Manhattan Bank*, 15 A.D.2d 769, 772–73 (1st Dep't 1962); *see also Gerrity Co., Inc. v. Bonacquisti Constr. Corp.*, 136 A.D.2d 800, 801-02 (3d Dep't 1989); *Utica Sheet Metal Corp. v. J. E. Schecter Corp.*, 53 Misc. 2d 284, 286–87 (Sup. Ct. Schenectady County 1967). Even absent its knowledge of Madoff's fraud, JPMC's knowledge that the 703 Account held customer funds would preclude it from exercising any right to setoff.

3. Setoff is an equitable remedy that would require factual findings and is not the proper subject of a motion to dismiss

The right to setoff is not absolute; rather, "[i]n determining if setoff is proper, a court must examine equitable considerations in the context of the goals and objectives of the Bankruptcy Code." *In re Enron Creditors Recovery Corp.*, 376 B.R. 442, 465 (Bankr. S.D.N.Y. 2007); *see also Warrington Mkt., Inc. v. Fleming Cos.*, 2003 WL 22594348, at *1 (E.D. Penn. Oct. 10, 2003). Based upon JPMC's knowledge of BLMIS's fraudulent activity, the equities would defeat any right it might otherwise have to obtain setoff. *See, e.g., In re Bennett Funding Group*, 146 F.3d 136, 140-41 (2d Cir. 1998). In any event, as with all of JPMC's arguments as to the Trustee's avoidance claims, the availability of setoff requires factual findings concerning the totality of the circumstances, and is therefore not the proper subject of a motion to dismiss. *Gerrity Co.*, 136 A.D.2d at 64–65.

CONCLUSION

For the foregoing reasons, the Trustee respectfully requests that the Court deny Defendants' motion in its entirety.

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Respectfully submitted,

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