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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	Adv. Pro. No. 08-01789 (LGB) SIPA LIQUIDATION (Substantively Consolidated)
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Substantively Consolidated SIPA Liquidation of Bernard L. Madoff Investment Securities LLC and the Chapter 7 Estate of Bernard L. Madoff, Plaintiff, v. MARTIN SAGE and SYBIL SAGE, Defendants.	Adv. Pro. No. 23-01098 (LGB)

TRUSTEE'S REPLY IN FURTHER SUPPORT OF MOTION TO COMPEL PRODUCTION OF DOCUMENTS AND TO AMEND COMPLAINT

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Irving H. Picard, the Trustee for the substantively consolidated SIPA liquidation of Bernard L. Madoff Investment Securities LLC and the chapter 7 estate of Bernard L. Madoff, submits this reply brief in further support of his motion to compel the Sages to produce documents responsive to the Trustee's First Set of Requests for Production and for leave to amend the Trustee's complaint in the instant action.[1] *See* Memo. of Law in Supp. of Mot. to Compel, ECF No. 59 ("Motion").[2]

I. The Taxing Authorities Were Mere Conduits of the Subsequent Transfers at Issue.

The Sages confirm in their opposition that resolution of the instant dispute turns on whether the Internal Revenue Service ("IRS") and the NYS Tax Department should be treated, under the Bankruptcy Code, as transferees or as mere conduits of the Subsequent Transfers. *See* Opp'n to Motion at 14–15, ECF No. 62 ("Opposition"). The Sages posit that "[o]nce [they] have established that the . . . Subsequent Transfers at issue . . . were fully spent, [they] have satisfied their discovery obligations." *Id.* And they contend that they "fully spent" the Subsequent Transfers by making income tax payments to the IRS and the NYS Tax Department. *Id.* at 17. According to the Sages, for purposes of the Bankruptcy Code, "[t]here can be no dispute that [they] 'transferred' their tax payments to the taxing authorities at the time that they filed their final 2006 and 2007 tax returns" and "the taxing authorities 'transferred' the tax refunds to the Sages." *Id.* But they offer no actual legal support to substantiate this position.

Rather, the substantial weight of authority establishes that the IRS and the NYS Tax Department were mere conduits as to substantially all of the payments they received from the Sages because they were legally required to refund the payments back to the Sages. Both the IRS

[1] Defined terms shall have the same meaning as prescribed in the Trustee's Motion.

[2] Unless otherwise noted, all ECF references herein refer to the instant action, *Picard v. Martin Sage*, Adv. Pro. No. 23-01098 (Bankr. S.D.N.Y.).

and the NYS Tax Department are statutorily required to refund any tax overpayment to a taxpayer. *See* 26 U.S.C. § 6402. And that is precisely what they did here.

Contrary to the Sages' contention, *In re Custom Contractors, LLC* is directly on point. 745 F.3d 1342 (11th Cir. 2014). In *Custom Contractors*, the Eleventh Circuit affirmed a lower court's ruling that the IRS could not be held liable as a transferee under the Bankruptcy Code as to income tax payments it received, which it ultimately had to refund:

> When the Debtor made the transfers to the IRS, it likely expected that Denson [the Debtor's principal] would accrue tax liability—otherwise, there would have been no legitimate reason for making the transfers. But, because that expectation was never realized, the IRS was always subject to the looming possibility that § 6402 would require the funds to be refunded to Denson. Thus, the IRS's rights were never as great as those held by a creditor receiving payment for a debt. Strings were always attached to the transfer, and Denson metaphorically pulled those strings by requesting a refund, bringing the funds from the IRS to Denson's bank account.

Id. at 1351. Although the payments at issue in *Custom Contractors* were estimated tax payments, the IRS is obligated to refund any overpayment regardless of whether it takes the form of an estimated tax payment or was made with the filing of an income tax return (a "final tax payment" in the Sages' parlance). *See, e.g.*, Instructions for Form 1040X (rev. Dec. 2010) (providing that Form 1040X "will be your new tax return" and "[t]he entries you make on Form 1040X . . . are the entries you would have made on your original return had it been done correctly"). The Sages further attempt to distinguish *Custom Contractors* by claiming that the "underlying reason" for their tax refunds they received was "investment losses." Opposition at 19. But the Sages are mistaken. They secured the refunds at issue by filing amended returns wherein they restated their taxable income on their 2006 and 2007 federal and state returns to—in their own words—"eliminate[] from taxable income" "all income and gains from Bernard L. Madoff . . . due to the arrest of Mr. Madoff and the announcement that any income reported from investments with Mr.

Madoff are fictitious." *See* Rollinson Decl., Ex. M (Proposed Am. Compl. ¶¶ 73, 75, 77, 79), ECF No. 60. The Sages received the refunds because they had mistakenly made overpayments to the taxing authorities.

The Sages' contention that the IRS and the NYS Tax Department did not issue the full refunds they sought, does not change how these authorities are to be viewed under the Bankruptcy Code as to the funds that they were required to—and did—refund to the Sages. In *Pergament v. Brooklyn Law School*, 595 B.R. 6 (E.D.N.Y. 2019), the court distinguished between tuition payments which were nonrefundable (in such case, the educational institution was deemed to be a transferee under the Bankruptcy Code) from those payments which were refundable (in such case, the institution was deemed to be a mere conduit under the Bankruptcy Code). In reaching this conclusion, the court relied on the Eleventh Circuit's decision in *Custom Contractors*. *Id.* at 16–17. Much like tax payments to a taxing authority, a university or law school does not have dominion or control (and thus is a "transferee" under the Bankruptcy Code) over tuition payments which are still subject to refund. *See id.* at 16 ("The lesson of *Custom Contractors* is that it is not the existence of the 'student accounts' that protects the schools in this appeal, but instead the undisputed real obligation of the schools to refund tuition payments to the debtor's children in the event that the children withdrew from classes. *Cf. Custom Contractors*, 745 F.3d at 1351 ("Strings were always attached to the transfer . . . .")). The Sages' attempts to distinguish *Pergament* is unavailing. *See* Opposition at 18, n.12 ("Taxing authorities do not issue tax refunds because a taxpayer notifies the authorities that she no longer wishes to pay taxes"; "A more apt analogy to this case is a demand that the university should refund the tuition because the student does not like the education she received."). The holding in *Pergament* has been widely accepted. *See, e.g.*, *In re Hamadi*, 597 B.R. 67 (Bankr. D. Conn. 2019); *In re Teston*, 646 B.R. 417 (Bankr. D. Md. 2022).

II. The Avoidance Actions Order Does Not Preclude the Discovery Sought Here.

The Avoidance Actions Order only applies to "Avoidance Actions" defined under the Order as "adversary proceedings commenced by the Trustee seeking the avoidance and recovery of preferences or fictitious profits (but not principal) under sections 78fff(b), 78fff-l(a) and 78fff-2(c)(3) of SIPA, sections 541, 542, 544, 547, 548, 550 and 551 of the Bankruptcy Code, sections 273 to 279 of New York Debtor and Creditor Law, and other applicable law." The Trustee does not seek to avoid any transfers here. The District Court already disposed of that issue in 2022. Accordingly, the Avoidance Actions Order cannot apply to this proceeding wherein the Trustee only seeks recovery of the avoided transfers from subsequent transferees.

Further, the Avoidance Actions Order provides that:

> Unless the parties agree to a broader scope, absent further order of the Court upon a showing of good cause, discovery will be limited solely and specifically to nonprivileged matters to the extent discoverable under Federal Rule 26(b)(1) which relate to . . . (i) the identity of other persons or entities that may be liable for the transfers at issue, whether as subsequent transferees or for some other reason.

Id. at § 4.G. Thus, even if the Avoidance Actions Order applies here, the discovery at issue is aimed at identifying persons and entities that may be liable for the Subsequent Transfers. Finally, the manner in which the Sages read the Avoidance Actions Order would preclude the Trustee from seeking discovery regarding their affirmative defenses in this action, which is nonsensical and further confirms that the Avoidance Actions Order cannot apply here. The Sages' filing of the Notice of Applicability is nothing more than an attempt to hide behind the Avoidance Actions Order to escape discovery of relevant documents—namely, the Sages' bank records for the time period that they received and made use of the tax refunds—which the Trustee believes will show that the Sages received the tax refunds jointly or that Sybil Sage received them individually and they made joint use of them.

III. The Court Should Grant the Trustee Leave to Amend the Complaint.

In their Opposition, the Sages maintain that the filing of the Trustee's Proposed Amended Complaint is futile and the Trustee is guilty of bad faith in attempting to do so. The Sages are wrong on both fronts.

To date the Sages have refused to disclose what became of the tax refunds at issue. The Trustee is aware that the refunds were jointly issued to the Sages given that they filed joint tax returns in 2006 and 2007. Accordingly, the tax refunds passed through the Sages' hands before being deposited in one or more accounts. And thus the Trustee can plausibly allege that the refunds were deposited into a joint account held by the Sages or one held solely by Sybil Sage shortly after their receipt.[3] *Ricciuti v. N.Y.C. Transit Authority*, 941 F.2d 119, 123 (2d Cir. 1991) (when deciding whether an amendment to a complaint would be futile, the court uses "the same standards as those governing the adequacy of a filed pleading"); *Mills v. Polar Molecular Corp.,* 12 F.3d 1170, 1174 (2d Cir. 1993) (in assessing the adequacy of a complaint, the court must "accept as true the factual allegations of the complaint, and draw all inferences in favor of the pleader").

Finally, the Trustee was not aware of all of the facts he alleges in the Proposed Amended Complaint at the time he commenced the instant proceeding. Specifically, the Trustee did not have the benefit of any of the Sages' bank records before filing his complaint herein. All that the Trustee knew (from the tax returns that Martin Sage produced in the underlying avoidance actions) was that the Sages made tax overpayments to the taxing authorities and thereafter sought tax refunds and that if refunds were issued, they were deposited into one or more bank accounts jointly held by the Sages (as those were the only types of accounts that Martin Sage disclosed in response to

[3] And it is certainly plausible that the Sages transferred the refund that they received from the NYS Tax Department into such an account after the Trustee commenced his avoidance action against, among others, Martin Sage in November 2010.

the Trustee's interrogatories during discovery in the underlying actions). It was only during discovery in the instant action that the Sages first disclosed to the Trustee their bank account records for the period of 2006 to 2009 and the Trustee first learned that Sybil Sage intended to raise the defense that—notwithstanding the fact that the Subsequent Transfers were deposited into her joint account with her husband—she did not exercise dominion or control over that account. The Trustee still does not know what bank accounts the Sages either jointly or individually held at the time that they received the tax refunds at issue but he can plausibly allege that the refunds were deposited into, or subsequently transferred to, such an account. The Sages' resistance to producing clearly relevant, properly discoverable documents relating to their receipt and use of the tax refunds is telling.

CONCLUSION

Based on the foregoing and as set forth in the Trustee's Motion, the Trustee respectfully seeks an Order compelling the Sages to produce documents responsive to the Disputed Requests as well as granting the Trustee's motion to amend.

Dated: May 23, 2025
New York, New York

Respectfully submitted,

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