UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BEACON ASSOCIATES LLC I, BEACON ASSOCIATES LLC II, ANDOVER ASSOCIATES, L.P., ANDOVER ASSOCIATES LLC I, ANDOVER ASSOCIATES (Q) LLC,

Plaintiffs,

-vs.-

BEACON ASSOCIATES MANAGEMENT CORP.; ANDOVER ASSOCIATES MANAGEMENT CORP.; INCOME PLUS INVESTMENT FUND; DAVID FASTENBERG, TRUSTEE, LONG ISLAND VITREO-RETINAL CONSULTANTS 401K FBO DAVID FASTENBERG, ET AL.,

Defendants.

Civil Action No.
1:14-cv-02294 (AJP)

MEMORANDUM OF DEFENDANT INCOME-PLUS INVESTMENT FUND IN REPLY TO DEFENDANT FASTENBERG'S MEMORANDUM OF LAW IN SUPPORT OF HIS REQUEST FOR A MANDATORY INJUNCTION AND DECLARATORY JUDGMENT

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PRELIMINARY STATEMENT

Defendant David Fastenberg, appearing as Trustee of the Long Island Vitreo-Retinal Consultants 401k FBO David Fastenberg ("Fastenberg"), advances two related but equally flawed arguments in favor of applying the Net Investment Method to the distribution of assets received by Beacon from the Madoff Trustee and from other sources stemming from the Madoff fraud.[1]

First, Fastenberg argues that the Net Investment Method[2] should displace the Valuation Method set forth in the operative contracts because equity "demands" use of that method. The argument is misplaced because it is premised on cases applying an equitable resolution to equitable claims – an issue distinct from the issue here, which involves a legal claim regarding the interpretation and enforcement of a contract. The argument is further inapposite because it conflates actions taken with respect to the unwinding of Ponzi schemes under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa *et seq*., with the liquidation of a legitimate investment fund such as Beacon.

Second, Fastenberg argues that the operative contracts should not be enforced because doing so would violate public policy. None of the cases cited by Fastenberg in support of this contention are remotely applicable here. Further, contrary to Fastenberg's argument, public

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[1] Capitalized terms in this Reply Memorandum are as defined in the Memorandum of Income-Plus Investment Fund in Response to Plaintiffs' Request for Declaratory Judgment, Dkt. No. 25, ("Income-Plus Opening Brief" or "IP Op. Br.") and in Defendant Fastenberg's Memorandum of Law in Support of His Request for a Mandatory Injunction and a Declaratory Judgment, Dkt. No. 30, ("Fastenberg Opening Brief" or "Fast. Op. Br."). Defendant Income-Plus Investment Fund ("Income-Plus") files this Reply Memorandum in further support of its position in favor of the Valuation Method set forth in the governing Beacon contracts.

[2] Income-Plus refers in the Income-Plus Opening Brief to the alternative methodology proposed by Fastenberg as the Net Equity Method, while Fastenberg refers to it as the Net Investment Method. Because this Reply Memorandum is in response to the Fastenberg Opening Brief, Income-Plus will adopt Fastenberg's nomenclature and refer to the alternative method at issue as the Net Investment Method.

policy favors the certainty and simplicity flowing from the enforcement of the operative contracts.

This Reply Memorandum is confined to the two arguments raised by Fastenberg in support of the Net Investment Method and certain other comments and arguments made in Fastenberg's Opening Brief. Income-Plus will not reiterate the principal arguments made in the Income-Plus Opening Brief regarding collateral estoppel, the clarity of the governing contracts, and the general inapplicability of the Net Investment Method to all future distributions anticipated from Beacon as it proceeds with its liquidation.

ARGUMENT

POINT I

EQUITY DOES NOT DEMAND USE OF THE NET INVESTMENT METHOD

Fastenberg argues that equity requires adoption of the Net Investment Method because the relief sought "is all equitable in nature." (Fast. Op. Br. p. 14.)[3] The argument is inconsistent with well-settled law regarding the nature of a declaratory judgment action.

"The fact that [an] action is in form a declaratory judgment case should not obscure the essentially legal nature of the action." *Simler v. Conner*, 372 U.S. 221, 223 (1963); *see also*

[3] Fastenberg cites several cases in support of its contention, but those cases are easily distinguishable. *DiTolla v. Doral Dental IPA of New York*, 469 F.3d 271, 275 (2d Cir. 2006) (involved an underlying action for an accounting, which, under New York law, "is a distinct cause of action rooted in equity"); *Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 389 (1919) (issue was whether court sitting in equity should decree a constructive trust); *Finance One Pub. Co. v. Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 343 (2d Cir. 2005) (applying the law of Thailand, which expressly granted the court "equitable discretion" to determine a set-off claim); *Kaminsky v. Kahn*, 23 A.D.2d 231, 259 N.Y.S.2d 716 (App. Div. 1st Dep't 1965) (equitable action for an accounting); *London v. Joslovitz*, 279 A.D. 280, 289, 110 N.Y.S.2d 58, 59 (App. Div. 3d Dep't 1952) (court defined an action seeking specific performance after expiration of a commercial lease as "an action in equity"); *Grand Union Co. v. Cord Meyer Dev. Co.*, 761 F.2d 141, 147 (2d Cir. 1985) (injunctive relief granted by court sitting in equity preserved parties' expectations under contract).

Petition of Rosenman & Colin, 850 F.2d 57 (2d Cir. 1988) (explaining that although "declaratory judgment actions are inherently neither equitable nor legal," it is "the nature of the underlying dispute" that is relevant). Thus, "courts have looked to the basic nature of the suit in which the issues involved would have arisen if Congress had not created the Declaratory Judgment Act, 28 U.S.C. §§ 2201, 2202." *SEC v. Eberhard*, 03 Civ. 813 (RMB), 2006 U.S. Dist. LEXIS 216, at **11-12 (S.D.N.Y. Jan. 3, 2006) (citing *American Safety Equip. Co. v. J.P. Maguire & Co.*, 391 F.2d 821, 824 (2d Cir. 1968); *accord Gulf Life Ins. Co. v. Arnold*, 809 F.2d 1520, 1523 (11th Cir. 1987)).

In *Simler*, the Supreme Court held that the plaintiff was entitled to a jury in a declaratory judgment action brought to determine the extent of the plaintiff's liability to an attorney under a retainer agreement because it involved common law contractual issues. *Simler*, 372 U.S. at 223. Similarly, in *Eberhard*, the Court concluded that a claim regarding the interpretation of a valid contract sounded in breach of contract and was, therefore, a legal claim. *Eberhard*, 2006 U.S. Dist. LEXIS 216, at *12.

Here, the central question placed in issue by the Complaint is whether Beacon should follow the distribution methodology set forth in the governing contracts. Income-Plus argues that, because Beacon's Operating Agreement is clear and unambiguous – as this Court recognized in its Initial Decision – there is no basis for what would in essence be an equitable reformation of the Agreement in favor of the Net Investment Method. *In re Dynegy Inc.*, 486 B.R. 585, 590 (Bankr. S.D.N.Y. 2013) (when contractual terms are clear and unambiguous, courts should not rewrite them "under the guise of interpretation," nor should a court redraft a contract to accord with its sense of equity on the facts) (quoting *Cruden v. Bank of N.Y.*, 957 F.2d 961, 976 (2d. Cir 1992) (internal quotation omitted)).

In sum, because the issues presented in this matter are primarily legal, the Court is constrained by the legal principles applicable to the law of contracts and should avoid application of the equitable principles advanced by Fastenberg.

POINT II

PUBLIC POLICY DOES NOT FAVOR USE OF THE NET INVESTMENT METHOD

Fastenberg also argues that "an order compelling the Beacon Funds to apply the Valuation Methodology" would "violate public policy." (Fast. Op. Br. p. 21.) Fastenberg offers no explanation, however, as to how the judicial enforcement of the contract would violate public policy when the contract: (i) was validly entered into by sophisticated parties; (ii) expressly contemplated the risk of the fraud Madoff perpetrated on Beacon; (iii) did not provide a different methodology for the distribution of assets in the event such a fraud came to fruition; but, rather, (iv) set forth a single methodology (the Valuation Method) for all liquidating distributions. The fact of the matter is that distribution pursuant to the terms of the contract will not violate public policy.

None of the three cases cited by Fastenberg remotely supports the sweeping contention that public policy favors disrupting the contractual relationships at issue here. In *New York State Corr. Officers & Police Benevolent Ass'n v. State*, 94 N.Y.2d 321 (1999), the New York Court of Appeals rejected an argument that an arbitration award reinstating a correctional department employee accused of flying a Nazi flag should be vacated on public policy grounds. Although the court opened the relevant discussion by stating the general proposition against enforcing contracts that violate public policy, it ruled that courts should not "vacate an award on public policy grounds when vague or attenuated considerations of a general public interest are at stake." *Id.* at 327.

The second case, *Oubre v. Entergy Operations*, 522 U.S. 422 (1998), is equally inapposite. In *Oubre*, the Supreme Court declined to enforce a release of age discrimination claims not because the release was contrary to a general public policy but, rather, because the contract itself was inconsistent with a statute containing express requirements regarding the enforceability of such releases. *Id.* at 424-425.

The third case, *SEC v. Credit Bancorp, Ltd.*, No. 99 Civ. 11395 RWS, 2000 WL 1752979 (S.D.N.Y. Nov. 29, 2000), does concern the distribution of assets in the context of an investment fund, but it has no bearing here because it involves an SEC enforcement action under which the court had "broad discretion to fashion an appropriate equitable remedy." Further, the SEC enforcement action involved a classic Ponzi scheme and not, as here, the distribution of assets to investors in a fund-of-funds governed by a contract mandating the use of the Valuation Method.

Finally, if public policy favors anything, it favors the use of the Valuation Method over the Net Investment Method because the Valuation Method is consistent with well-settled contract law and allows for the simple and straightforward distribution of Beacon's remaining assets without the complications that will follow if the Court orders the use of the Net Investment Method for certain assets and the Valuation Method for others. Those complications include not only issues arising from how to deal with expenses (*see* Compl. ¶ 38, p. 11), but also any issues that may arise relating to the accuracy of the Net Investment Method calculations.[4]

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[4] For example, in reviewing cash flow information provided by Beacon, it appears that at least one investor may have an inflated net equity based on confusion as to whether funds were deposited by that investor or transferred from another Beacon investment account. If the latter, the investment amounts credited to that investor would have been inflated by profits reported by Madoff before discovery of his fraud. The amount is not insignificant, with Income-Plus' review suggesting the net equity attributed to this investor could be overstated by as much as $7 million. Another issue that would require resolution would be how to deal with certain investors who were allowed to track their investment with Madoff's returns. Allowing those investors to reverse course and calculate future distributions based on their cash in/cash out to Beacon would be inconsistent with their initial request to tie their fortunes solely to Beacon's Madoff investment.

POINT III

THE NET INVESTMENT METHOD AS IDENTIFIED IN THE COMPLAINT DOES NOT PROVIDE A MORE EQUITABLE DISTRIBUTION OF BEACON'S REMAINING ASSETS

There are a variety of additional arguments and comments sprinkled throughout the Fastenberg Opening Brief that bear a response here.

First, Fastenberg argues that courts in Madoff-related proceedings addressing similar issues to those at issue here have uniformly rejected the Valuation Method. (*See* Fast. Op. Br. pp. 4 & 16-20.) In the first instance, the argument ignores this Court's Initial Decision ordering distribution of Beacon's remaining assets under the Valuation Method based on the relevant contract provisions, as well as the inapplicability of the Madoff Trustee's Net Investment Method. (*See* IP Op. Br., pp. 5-6 & 8-13.) Thus, it is incorrect to state that all of the courts examining the issue in general have resolved it by applying the Net Investment Method.

In addition, all of the courts applying the Net Investment Method have done so in the context of the unwinding of an actual Ponzi scheme, and not in the context of the liquidation of a fund-of-funds like Beacon. In fact, none of the cases cited by Fastenberg involve the precise issue here – the distribution of the remaining assets of a fund-of-funds that invested in Madoff but had other, legitimate investment managers. [5]

Second, Fastenberg argues that the money returned or to be returned to Beacon is all "Madoff money," thus justifying the use of the Net Investment Method. (Fast. Op. Br., p. 5.) The argument is inconsistent with the fact that there is no such thing as "Madoff money" in

[5] Although one of the cases cited by Fastenberg, *Hecht v. Andover Assoc. Mgt. Corp.*, 114 A.D.3d 638, 979 N.Y.S.2d 650 (App. Div. 2d Dep't 2014), involves one of the fund-of-funds at issue here, the decision has nothing to do with distributions and simply finds that the fund itself "did not suffer any loss with respect to the fictitious" profits reported by Madoff.

Beacon. The "Madoff money/Non-Madoff money" is, at bottom, a fiction designed to avoid this Court's Initial Decision requiring the distribution of Beacon's remaining assets under the Valuation Method. As this Court found in its Initial Decision, and as the governing contracts make very clear, funds deposited by investors into Beacon became assets of Beacon and were not traceable to any particular investment manager in Beacon, including Madoff. (IP Op. Br., pp. 17-18.)

Third, Fastenberg argues that using the Valuation Method would "convert the Beacon Funds into a Ponzi scheme where earlier investors receive fictitious profits from later investors, and later investors do not even get their investment back." (Fast. Op. Br., p. 5.) Fastenberg offers no case citation in support of the contention, nor is it logical to suggest that a distribution made pursuant to the terms of a contract – and based on a court order enforcing that contract, which would be the case here – could conceivably be characterized as creating a Ponzi scheme. The point ignores the hidden and fraudulent aspects of a Ponzi scheme. Further, it impossible to say whether later investors will or will not "get their investment back," particularly given the fact that the Net Investment Method identified in the Complaint does not account for the substantial moneys paid to investors as a result of the settlement of the class action and related litigation referenced in the Complaint, as well as the receipt of recoveries from other potential collateral sources. (IP Op. Br., pp. 21-22.)

Fourth, Fastenberg suggests that the remaining assets in Beacon as of the Court's Initial Decision in 2010 "were comprised solely of non-Madoff profits and return of non-Madoff capital." (Fast. Op. Br., p. 11.) This not only ignores the fact that there is no such thing within Beacon as "Madoff" and "Non-Madoff" assets, but also glosses over the fact that one of the

assets of Beacon at the time of the Initial Decision was Beacon's substantial proof of claim as submitted to the Madoff Trustee. (IP Op. Br., p. 11.)

Finally, Fastenberg states that the New York Attorney General and the Department of Labor "insisted that the distribution amounts paid directly to Beacon investors" pursuant to the settlement of the class action and related litigation referenced in the Complaint (Compl. ¶ 37) "be calculated using the Net Investment Method, and not the Valuation Method." (Fast. Op. Br., p. 13.) Fastenberg provides no supporting material for that contention. However, an affidavit filed in support of approval of the settlement distribution by Lynda S. Borucki, an expert retained by plaintiffs in the class action and related litigation, reveals consideration of a variety of distribution scenarios and complex settlement negotiations regarding the distribution. (Declaration of Brian E. Whiteley, dated September 5, 2014 ("Whiteley Dec.") ¶ 2, Ex. 1 at ¶¶ 21-24 & 35.) The Borucki affidavit also says the New York Attorney General requested that the distribution be designed to make Beacon investors "whole" – assuming a projected recovery from the Madoff Trustee of 60% of Beacon's net investment. (Whiteley Dec. ¶ 2, Ex. 1 at ¶ 25.)

The relevance here is three-fold. First, assuming the Department of Labor and the New York Attorney General in fact "insisted" on payments directly to the Beacon investors (which is in fact what happened), it is reasonable to infer that the basis for that position was a recognition of the fact that, had the dollars been paid to Beacon, they would have been subject to Beacon's contractually-mandated distribution methodology. Second, it is clear that the ultimate allocation arising from the class action and related litigation was the result of complex and private settlement discussions that cannot possibly serve as the model for a judicial decision regarding the appropriate distribution here. And third, by expressly referencing a projected recovery to Beacon of 60% of Beacon's net investment without any reference to a distribution by

Beacon in a manner divorced from its governing contracts, it is more than fair to infer that the calculations would have assumed a distribution by Beacon to investors under the Valuation Method.

CONCLUSION

For the reasons set forth in this Reply Memorandum and in the Income-Plus Opening Brief, Defendant Income-Plus Investment Fund respectfully requests that this Court issue an Order mandating that all remaining assets of Beacon, including any assets received to date and in the future from the Madoff Trustee, and also including the proceeds of any litigation settlements relating to Beacon's Madoff-related investments, whether received or to be received in the future, be distributed under the Valuation Method, together with such other and further relief this Court may deem just and proper.[6]

DATED: September 5, 2014

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[6] In Income-Plus' Opening Brief, Income-Plus identified the amount of approximately $75 million it believed to be available for distribution in the near future. (IP Op. Br. p. 6.) That number is incorrect because it included the approximately $19.7 million that had initially been withdrawn from investor accounts to be held in reserve with respect to the Madoff Trustee's clawback claim. The funds were withdrawn from investor accounts after disclosure of Madoff's fraud and were thus taken from what Beacon has identified as "non-Madoff money." Such funds were distributed to investors in accordance with the Valuation Method as previous directed by this Court. In the Complaint, at paragraph 38(a), (b) and elsewhere, Plaintiffs seek a Declaration as to how these funds should be designated. These funds – as well as other recovered funds – should be distributed in accordance with the Valuation Method, and thus Beacon's designation of these funds as what it has identified as "non-Madoff money," and distribution of such funds in 2013 in accordance with the Valuation Method, was appropriate. As explained above, Income-Plus was mistaken when including that amount as still available for future distributions and, in fact, requests that the Court declare that distributing those funds under the Valuation Method was appropriate under the Beacon Operating Agreement.

CERTIFICATE OF SERVICE

I hereby certify that on September 5, 2014, I electronically filed the foregoing Memorandum of Defendant Income-Plus Investment Fund in Response to Plaintiffs' Request for a Declaratory Judgment using the CM/ECF system, which sent electronic or other notification of such filing to all counsel of record in this case, and a copy was also sent by first class mail to all counsel of record.

*_/s/ Brian E. Whiteley_*
BRIAN E. WHITELEY