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 (QP) 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,

Defendants.

Index No. 14-cv-2294

DEFENDANT FASTENBERG'S REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF HIS REQUEST FOR A MANDATORY INJUNCTION AND A DECLARATORY JUDGMENT

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Defendant David Fastenberg, by his attorneys, Folkenflik & McGerity LLP, submits this Reply Memorandum of Law in Futher Support of His Request for a Mandatory Injunction and a Declaratory Judgment.

PRELIMINARY STATEMENT

Income Plus Investment Fund ("Income Plus") argues for the blanket application of the Valuation Method for all distributions from the Beacon Funds[1] as if the decision to be made now is, in essence, the same as the decision the Court previously faced. But the situation is dramatically different.

[1] The Plaintiffs, Beacon Associates LLC I, Beacon Associates LLC II, Andover Associates L.P., Andover Associates LLC I, and Andover Associates LLC (QP) are hereinafter referred to collectively as the "Beacon Funds" or the "Funds".

First, and most importantly, the core dispute in this matter arises from the fact that Income Plus, and other investors aligned with it, believe the same "Valuation Method" should apply to distributions of money received from the Estate of Bernard L. Madoff Investment Securities LLC ("BLMIS") (The Trustee of the BLMIS Estate, Irving H. Picard, is hereinafter referred to as the "Trustee"). Fastenberg, and investors aligned with him, believe that, as to recoveries of "Madoff money," the case law and equity demand that computation of distributions must be made by application of the Net Investment Method (sometimes called the "Net Equity Method," or cash in/cash out).

As we readily conceded in our papers, and as Income Plus points out, Fastenberg argued on the last motion that the Valuation Method should have been applied to the Non-Madoff money which was then the focus of the dispute. We still believe that the Valuation Method should be applied to any Non-Madoff money. It is true that both the Valuation Method and the Net Investment have flaws and blind spots, and blanket application of either will result in substantial inequities. The hybrid blended approach minimizes those inequities and is, therefore, by far, the most equitable.

ARGUMENT

POINT I

COLLATERAL ESTOPPEL DOES NOT APPLY TO THE DISTRIBUTION DECISION TO BE MADE ON THIS MOTION

Income Plus argues strenuously that collateral estoppel bars re-litigation of the Court's prior "decision on the proper method for distribution of Beacon's assets." Income Plus Mem., at 8, Point I. The argument is misguided since the issue of how to distribute Madoff money was not within the scope of the claims raised in the prior case, nor was it an issue actually litigated.

As the facts of prior litigation set forth in the Declaration of Max Folkenflik conclusively demonstrate, the prior action was addressed solely to the question of what method should be used by Beacon to distribute the cash assets then on hand, and not how to distribute future assets, particularly Madoff assets, which might possibly be recovered at a later time. See, Complaint, Exhibit A to Folkenflik Decl. 8/27/14, ¶ 2; Fastenberg Intervenors' Memorandum of Law in Support of Motion for Declaratory Judgment, at 2 [Docket No. 25]; Folkenflik Decl. ¶¶ 7-13.

Indeed, the Madoff investment was not treated by the Beacon Funds as an asset, and was valued at zero on the Beacon Funds' financial statements. See, 2008 Audited Financial Statements annexed to the Folkenflik Decl. 09/05/14 as Exhibit A, at page 9, footnote 4; Folkenflik Decl. 09/05/14 ¶ 6. Nor were the investors alerted to the possibility that the Court's decision might apply to future distributions of Madoff money when they were asked to vote on the various potential distribution methods. See, Folkenflik Decl. 9/5/14 ¶ 7.

Collateral estoppel is sometimes referred to in opinions collectively with res judicata, but the two concepts are conceptually different. As the Supreme Court has explained it:

> Under the doctrine of res judicata, a judgment on the merits in a prior suit bars a second suit involving the same parties or their privies based on the same cause of action. Under the doctrine of collateral estoppel, on the other hand, the second action is upon a different cause of action and the judgment in the prior suit precludes relitigation of issues actually litigated and necessary to the outcome of the first action.

Parklane Hosiery Co. v. Shore, 439 U.S. 322, 327 (1979).

As the Second Circuit has held:

> The doctrine of res judicata, or claim preclusion, provides that a final judgment on the merits in one action bars subsequent relitigation of the same claim by the same parties and by those in privity with the parties. *N.L.R.B. v. United Technologies Corp.*, 706 F.2d 1254, 1259 (2d Cir. 1983). That bar extends both to "issues actually decided in determining the claim asserted in the first action and [to] issues that could have been raised in the adjudication of that claim." However, preclusion is limited to the transaction at issue in the first

> action. Litigation over other transactions, though involving the same parties and similar facts and legal issues, is not precluded.

Greenberg v. Board of Governors of Fed. Reserve Sys., 968 F.2d 164, 168 (2d Cir. 1992).

"Claims arising subsequent to a prior action," based on conduct occurring after the commencement of the earlier suit, and sufficient to state a cause of action without the need to incorporate facts preceding the first suit "need not, and often perhaps could not, have been brought in that prior action," and so are not barred by res judicata "regardless of whether they are premised on facts representing a continuance of the same 'course of conduct.'" *TechnoMarine SA v. Giftports, Inc.*, 2014 U.S. App. LEXIS 13487, 13-15 (2d Cir. July 15, 2014), *citing*, *Storey v. Cello Holdings, L.L.C.*, 347 F.3d 370, 383.n5 (2d Cir. 2003).

Since the prior action was specifically directed at the release of then existing cash assets of the Beacon Funds, the claim in this case seeking to compel the release of other cash assets, not in existence at the time of the first suit, coming from an entirely different source, and involving entirely separate equitable considerations, is certainly not the same "claim." Income Plus apparently agrees.

Income Plus, therefore, invokes only the doctrine of collateral estoppel, or issue preclusion. The question before the Court, therefore, is whether the core issue presented by this case, what method should be used to distribute recoveries received from the Madoff Trustee, was "actually litigated and necessary to the outcome of the first action."

Just months ago, the Second Circuit delineated the applicable law:

> This Circuit's requirements for issue preclusion are similar: "(1) the issues in both proceedings are identical, (2) the issue in the prior proceeding was actually litigated and actually decided, (3) there was a full and fair opportunity for litigation in the prior proceeding, and (4) the issues previously litigated were necessary to support a valid and final judgment on the merits."

W&D Imps., Inc. v. Lia, 563 Fed. Appx. 19, 22 (2d Cir. 2014), *quoting*, *NML Capital, Ltd. v. Banco Cent. de la Republica Argentina*, 652 F.3d 172, 185 (2d Cir. 2011).

The proponent of collateral estoppel has the burden of showing that the doctrine should be applied. *Beechwood Restorative Care Ctr. v. Leeds*, 436 F.3d 147, 153 (2d Cir. 2006).

Income Plus' argument that this entire proceeding is precluded by collateral estoppel fails on all prongs of the Second Circuit test.

First, as to the "issue identity prong," Income Plus cites *Zherka v. City of New York*, 459 Fed. Appx. 10, 13 (2d Cir. 2012) for the proposition that "it is not necessary that the issues be exactly identical; it is sufficient that 'the issues presented in [the earlier litigation] are substantially the same as those presented by [the later] action.'" *Id.* (citation omitted); see, Income Plus Mem. at 10. "Collateral estoppel does not apply however when the essential facts of the earlier case differ from the instant one, even if they involve the same legal issues. When the facts essential to a judgment are distinct in the two cases, the issues in the second case cannot properly be said to be identical to those in the first, and collateral estoppel is inapplicable." *Montana v. United States*, 440 U.S. 147, 159, 59 L. Ed. 2d 210, 99 S. Ct. 970 (1979).

The issue of the proper method of computing distribution of Madoff money is certainly not "substantially the same" as the issue of how to distribute Non-Madoff money. Because of the differing equities involved in those two questions, no matter how the Court ultimately decides the outcome, it must certainly be admitted that the source of the money is a "fact essential to" determining which method of distribution should be applied.

Income Plus attempts to argue that the issues can be treated as "identical" because the only difference between the two pools of money is that the Madoff money was "not liquid." Income Plus Mem. at 11. However, that is not our argument at all. The difference is that the

Madoff money was all stolen, all part of a Ponzi scheme, and all is being returned to Beacon on based Net Equity calculation method which disregards fictitious Madoff profits and looks only at cash deposited and withdrawn. Whether those fictitious profits should be re-introduced into the distribution equation is certainly a separate issue, and one which was not presented in the initial case.

Second, Income Plus' arguments about actual litigation of the issues and the actual decision of the issues, treated together as one argument, *see*, Income Plus Mem. at 11, also misses our essential argument, by focusing on the terms of the Operating Agreement alone. As this Court recognized in its prior opinion, the question of what the Operating Agreement requires is only part of the question this Court must resolve. The other issues, and in this case the determinative issues, are what "equity demands," and "considerations of public policy." *Beacon Assocs. Mgmt. Corp. v. Beacon Assocs. LLC I*, 725 F. Supp. 2d 451, 463 (S.D.N.Y. 2010). None of those issues relating to distribution of the Madoff money were raised or litigated in the Complaint or any of the moving papers. As pointed out in the Declaration of Max Folkenflik submitted herewith, the issue of a Net Investment Method was never even raised except by submissions by investors. The parties were focused on the Valuation Method versus the other three alternatives put fourth by the Beacon Fund accountants.

Third, Income Plus does not even address the fourth requirement for a finding of collateral estoppel, whether the issue of how to distribute Madoff Money was "necessary to support a valid and final judgment" on the how to distribute the Non-Madoff money. It obviously was not.

We do agree, however, that the issue of the interpretation of the Operating Agreement was resolved in the earlier proceeding and should be given preclusive effect. We also agree that

the issue of the equities and public policy of applying the Operating Agreement to distributions of Non-Madoff money were also resolved and should govern any further distributions of Non-Madoff money. However, Income Plus has not sustained its burden, and cannot sustain its burden of showing that any other issues determined in the prior proceeding should be afforded preclusive effect.

POINT II

CONSIDERATIONS OF EQUITY AND PUBLIC POLICY GOVERN THE DECISION IN THIS CASE

Were this an action at law to enforce a lawful contract, we would agree generally with the proposition of contract interpretation advanced by Income Plus that the Court should not redraft unambiguous contracts to comport with a Judge's private sense of equity. See, Income Plus Mem. at 18-19, citing, *In re Dynegy Inc.*, 486 B.R. 585, 590 (Bankr. S.D.N.Y. 2013). But that proposition of law has nothing to do with the issues before this Court.

First, it has long been established by common law that contracts "contrary to public policy are not enforceable." *Beth Isr. Med. Ctr. v. Horizon Blue Cross & Blue Shield of N.J., Inc.*, 448 F.3d 573, 580 (2d Cir. 2006), *quoting* , *64th Associates, L.L.C. v. Manhattan Eye, Ear & Throat Hosp.*, 2 N.Y.3d 585, 589-90, 813 N.E.2d 887, 780 N.Y.S.2d 746 (N.Y. 2004); ("Ordinarily, courts are not involved in the oversight or approval of contracts and will enforce them unless illegal, against public policy or deficient in some other respect."), *see*, also, *Oubre v. Entergy Operations*, 522 U.S. 422, 431 (1998) (a contract which violates the law or public policy is void).

That point is also made in *Lanier v. Bowdoin*, 282 N.Y. 32, 38 (1939), cited with approval in this Court's prior decision (agreements between partners will be enforced in "the

absence of … considerations of public policy"). *Beacon Assocs. Mgmt. Corp. v. Beacon Assocs. LLC I*, supra., 725 F. Supp. 2d at 464.

As we pointed out in our moving papers, "recognizing claims to profits from an illegal financial scheme is contrary to public policy because it serves to legitimate the scheme." *SEC v. Credit Bancorp, Ltd.*, No. 99 Civ. 11395 RWS, 2000 WL 1752979, at *40 (S.D.N.Y. Nov. 29, 2000). See also, Fastenberg Moving Mem. at 21-22. Yet the proposal to distribute Madoff money on the basis of a Valuation Method significantly affected by the Madoff fictitious profits would do just that.

Second, this is not a suit to enforce a contract, but a suit for equitable declaratory and injunctive relief. As such, in the words of Judge Cardozo, "[t]he equity of the transaction must shape the measure of relief." *Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 389 (1919). See, also, Fastenberg Moving Mem. at 14-20.

As a result, Income Plus is simply wrong when it asserts that granting the relief we seek "would require reforming the Operating Agreement." Income Plus Mem. at 18. They cite no case, and we are aware of none, which would restrict this Court's power in an equitable action to shape an equitable remedy based on equitable considerations, or to deny enforcement of a contract which violates public policy.

Nor would applying equitable principles be inconsistent with ERISA as Income Plus argues. The ERISA cases cited, such as *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 83-84 (1995), address the need to have a clear ERISA benefit plan, and have nothing to do with the entirely separate issue of how a fund in which and ERISA plan invests should distribute assets received by that fund.

POINT III

USING THE NET INVESTMENT METHOD FOR DISTRIBUTIONS OF MADOFF MONEY AND THE VALUATION METHOD FOR DISTRIBUTIONS OF NON-MADOFF MONEY IS THE MOST EQUITABLE METHOD OF DISTRIBUTION

On the last motions relating to the distribution of Non-Madoff assets, this Court noted the counterveiling equities presented there, including the fact that applying the Net Investment Method in that case would "strip investors of legitimate gains from Beacon's significant non-Madoff investments," *Madoff I* 725 F. Supp. 2d at 464, and the potential for expense, litigation and delay if the Net Investment Method was adopted. *Id.* n.22. As a result the Court was "unpersuaded that equity demand[ed]" that the Valuation Method set forth in the Operating Agreement should not be followed. *Id.* at 464.

Here, however, the previously identified counterveiling equities do not exist, and the simple question is whether equity allows this Court to order that early investor fictitious profits should be paid from funds invested by later investors, thereby causing the exact type of inequity on which every Ponzi scheme depends. Such a result would create inequity, not remedy it.

Contrary to Income Plus's argument, the hybrid approach does give deference to the contractual agreement among the Beacon investors, as reflected in the Operating Agreement. All distributions of Non-Madoff money are made exactly as the Operating Agreement requires. There were, surely, profits earned by the Non-Madoff investment managers and earlier investors receive full credit for those amounts. But equally without dispute, a substantial portion of the historically reported profits was earned as a result of Madoff's crimes.

Applying the Valuation Method to the Non-Madoff money without any reduction of their percentage "sharing ratio" to correct for inflation caused by Madoff's fictitious profits does

create some inequity for those, generally later investors, with lesser Madoff fictitious profits, as this Court has recognized. Application of the Net Investment Method for the Madoff money ameliorates, albeit imprecisely, the inequities caused by the impact of fictitious profits on the Valuation Method calculation.

The Net Investment Method for the Madoff money also avoids the inequities of treating fictitious profits as real and using Madoff Money just as Madoff did, to have earlier investors reap the reward of fictitious profits at the expense of later investors. Income Plus does not even address at all the differences in the equities between recoveries and distribution of Madoff money and the recovery and distribution of money from legitimate investments.
Those inequities, which Income Plus argues this Court should *require*, would violate public policy and the broad reach of the opinion by the Second Circuit in *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 238 (2d Cir. 2011). By blending the two distribution methods, the inequity of choosing either distribution method exclusively are diminished and perhaps avoided.

Income Plus does not address the equitable advantage of having a blended approach depending on the source of the money. Instead, it acts as if the decision faced by this Court is binary, and either one approach or the other must be endorsed. Neither one of those approaches will be as equitable as the blended/hybrid approach using both.

POINT IV

EXPENSES SHOULD BE ALLOCATED 50% BY THE NET INVESTMENT METHOD AND 50% BY THE VALUATION METHOD

The remaining issue raised by the Declaratory Judgment Complaint is how to allocate expenses. We propose that they be split 50/50 between the Valuation Method and the Net Investment Method based on the relative shares of those two methods following the initial

distributions pursuant to this Court's order on this motion. The split between those who are "benefited" by the Valuation Method and those who are "benefited" by the Net Investment Method on this distribution seems to be about in those proportions. See, Jeanneret Decl. ¶ 19 (on a dollar weighted basis, 54% benefit from the Valuation Method). It also has the great benefit of simplicity and therefore will lead to less expense . It will also, if adopted, avoid potentially time consuming, and expensive disputes over the implementation of the formula.

CONCLUSION

For all of the above reasons, Defendant Fastenberg respectfully requests that the motion be granted in all respects, and that a mandatory injunction be issued requiring distribution of the Madoff recoveries from the Trustee based on the Net Investment Method.

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Respectfully submitted,

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