Ponzi Scheme Transfers by Hedgefund to Broker Avoided in Bankruptcy

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In a decision with potential far-reaching effects on Wall Street firms servicing hedge funds as prime brokers, on February 15, 2007, a New York bankruptcy court ordered Bear Stearns to disgorge nearly $160 million that it received in the form of margin payments, position closeouts and fees from a hedge fund that had engaged in a ponzi scheme because, among other things, the broker failed to adequately monitor the activities of the fund before it collapsed in 2000. If the court's decision is upheld on appeal, broker-dealers might be obligated to oversee more diligently the activities of their lucrative clients.

Factual Background

Manhattan Investment Fund, Ltd. (the "Fund"), a hedge fund created and used by Michael Berger ("Berger") through his wholly owned company Manhattan Capital Management, Inc. ("MCM"), maintained an account at Bear Stearns. The monies in the account were used by the Fund to engage in securities trading. The account was subject to an industry-standard account agreement, which contained boilerplate provisions granting Bear Stearns: (1) discretion to set the level of maintenance margin; (2) a security interest in all monies held in the account; (3) sole discretion to prevent the Fund from withdrawing any monies credited to the account as long as any short positions remained open; and (4) sole discretion to use any and all monies credited to the Fund's account to liquidate the Fund's open short positions with or without the Fund's consent.

According to the Bankruptcy Court, in December 1998, Bear Stearns was put on notice of possible fraud being perpetuated by Berger. A senior managing director and salesperson at Bear Stearns was informed that the Fund was reporting 20% profit a year. Yet, the same individual understood that the Fund was losing money based upon his participation in risk-related conference calls in which the Fund was mentioned. After going through some internal channels and confirming that the Fund was losing money in its Bear Stearns account, Bear Stearns contacted Berger regarding the discrepancy. Berger explained that the discrepancy was due to the fact that Bear Stearns was one of eight or nine prime brokers utilized by the Fund. Despite continued suspicion and rising margin requirements, Bear Stearns did not verify Berger's representation until many months later, when Bear Stearns discovered that it was the only prime broker for the Fund.

On January 14, 2000, following an investigation into the Fund's trading activities, the SEC discovered that the Fund was in fact a ponzi scheme, and filed a securities fraud complaint against the Fund, MCM and Berger. The Fund, through its receiver, filed a bankruptcy petition on March 7, 2000. The receiver was later appointed chapter 11 trustee of the Fund, and on April 24, 2000, commenced an adversary proceeding against Bear Stearns seeking, among other things, the avoidance of 18 transfers totaling $141.1 million in margin payments, which Berger caused to be transferred to the Fund's Bear Stearns account from the Fund's account with the Bank of Bermuda, and which were then used by the Fund to engage in securities trading.

The Bankruptcy Court's Opinion

The bankruptcy court granted summary judgment to the trustee and ordered Bear Stearns to pay nearly $160 million to investors in the Fund. The bankruptcy court held that:

- The margin payments transferred into the Fund's Bear Stearns account were made by the Fund with actual intent to hinder, delay or defraud its creditors, and therefore subject to avoidance under section 548(a)(1)(A) of the Bankruptcy Code;
- Because the transfers were made to open new short positions or to comply with margin requirements, they "fit squarely" within the definition of margin payments, which are protected from avoidance by a bankruptcy trustee under section 546(e) of the Bankruptcy Code, known as the "stockbroker defense," unless made with actual intent to hinder, delay or defraud creditors;
- Transfers made to Bear Stearns in furtherance of a fraudulent ponzi scheme were effectuated with actual intent to defraud creditors, so that the "stockbroker defense" does not preclude avoidance of the payments;
- Bear Stearns qualified as an "initial transferee" under section 550(a)(1) of the Bankruptcy Code, rather than a "mere conduit" that did not exercise dominion and control over the funds, and therefore was liable to return the payments;
- Public policy did not prevent recovery of the margin payments; and
- Bear Stearns could not rely upon the good-faith defense under section 548(c) of the Bankruptcy Code.

Bear Stearns argued that it was a "mere conduit" as opposed to an "initial transferee" and, thus, was not required to return the margin payments. The bankruptcy court rejected this argument, holding that Bear Stearns exercised "dominion and control" over the transfers, noting that Bear Stearns used the funds in the account to cover all open positions the Fund had with Bear Stearns, positions for which Bear Stearns would have been liable if the transfers had not been made. Moreover, under the Account Agreement, Bear Stearns had a security interest in any monies transferred, held transferred monies as collateral for short sales, had the right to and did in fact prohibit the Fund from withdrawing any monies so long as the short positions remained open,

and had the right to and did in fact use the monies to purchase covering securities, at its discretion. In sum, because Bear Stearns had the ability to exercise control and use the transferred monies to protect itself, it was not a "mere conduit."

The bankruptcy court also rejected Bear Stearns' argument that finding a securities brokerage as an initial transferee, based on boilerplate provisions in the industry-standard Account Agreement, would expose all broker-dealers to massive liability and would cripple the securities industry. The court noted that the provisions of the Bankruptcy Code permit margin payments to be avoided in only limited circumstances (*i.e.*, in cases of actual, rather than constructive, fraud) and that, since the Bankruptcy Code specifically allows for avoidance of margin payments, it cannot be said that allowing exactly that is contrary to public policy.

Finally, the bankruptcy court held that Bear Stearns could not rely upon the good faith defense under section 548(c) of the Bankruptcy Code because it found that Bear Stearns either knew or should have known of Berger's fraud beginning in December 1998. The bankruptcy court noted that the standard for determining whether the transferee lacked knowledge of the fraud (so as to have been acting in good faith) was objective and courts look to what the transferee knew or should have known. The bankruptcy court held that "Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong . . . [d]iligence required consulting easily attainable sources of information that would bear on the truth of any explanation received from the wrongdoer."

Conclusion

Lawmakers clearly recognized the importance of minimizing disruption to the nation's securities markets when they added the "stockbroker's defense" in section 546(e) to the Bankruptcy Code in 1982. Comparable safe harbors were enacted in 1984, 1990 and 2005 to protect margin, settlement or other payments under repurchase, swap and master netting agreements. In all of these cases, however, the safe harbor does not preclude avoidance of transfers made with the actual intent to hinder, delay or defraud creditors.

Brokers have long relied on section 546(e), the "mere conduit" exception to "transferee" status in section 550 and the "good faith" safe harbor in section 548(c) to insulate themselves from potential exposure when a customer winds up in bankruptcy and the trustee scrutinizes payments or transfers made within the statutory avoidance periods. The bankruptcy court's ruling in *Manhattan Investment Fund* suggests that blind reliance on these provisions is misplaced and that brokers bear a heavier burden of inquiry concerning the activities of their clients incident to establishing "good faith."

Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund Ltd.), 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007).

Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund Ltd.), 2007 WL 534547 (Bankr. S.D.N.Y. Feb. 15, 2007).