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# PARTIAL REVERSAL OF *MANHATTAN INVESTMENT FUND* DECISION LEAVES PRIME BROKERAGE OPERATIONS AT RISK

In December, the United States District Court for the Southern District of New York overturned, but only partially, a Bankruptcy Court decision granting summary judgment against a prime brokerage (the "Bank") and ordering the Bank to return $141 million in margin payments plus pre-judgment interest of $38 million to the Trustee for the estate of bankrupt Manhattan Investment Fund Ltd. (the "Manhattan Fund"). *See In re Manhattan Inv. Fund Ltd.*, Adv. Pro. No. 01-2606 (S.D.N.Y. Dec. 17, 2007) (Memorandum Opinion and Order). The case stems from a Ponzi scheme executed by Manhattan Fund's founder Michael Berger, who has pleaded guilty to and was convicted of his crimes.

As we reported in 2007, the Bankruptcy Court's decision had potentially far-reaching implications for all prime brokerages because the Bankruptcy Court held, among other things, that (i) the Bank was an "initial transferee" of certain margin payments made by Manhattan Fund under Section 550(a) of the Bankruptcy Code, (ii) the Bank was not a "mere conduit" but had "dominion and control" over the transferred funds pursuant to standardized terms in the prime brokerage agreement that permitted the Bank to use the funds to secure its own exposure to the Manhattan Fund, and (iii) as a matter of law, the Bank could not prevail on "good faith" defense to preclude an avoidance of the margin payments under Section 548(c) of the Code. The District Court's decision disturbed only the last holding of the Bankruptcy Court.

The District Court affirmed the Bankruptcy Court's holding that margin payments transferred into the Fund's account were made in furtherance of Manhattan Fund's fraudulent Ponzi scheme and were made with actual intent to hinder, delay, or defraud the Fund's creditors. The margin transfers to the Bank were therefore subject to avoidance under Section 548(a)(1)(A) of the Bankruptcy Code. The District Court also affirmed the Bankruptcy Court's holding that the Bank was an "initial transferee" under Section 550(a) of the Bankruptcy Code and therefore potentially liable to return the

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margin payments. In so doing, the District Court found that the Bank was not a "mere conduit," but had "dominion and control" over the transfers based, in part, on an industry-standard account agreement that granted the Bank certain rights to use the funds in the account to protect itself.

The primary point of disagreement and the reason for the partial reversal was the District Court's determination that the Bank was entitled to a trial to attempt to establish its "good faith" defense under Section 548(c). Even though the trial will necessarily be a bench trial, the opportunity to make a more fulsome evidentiary showing and to conduct live direct and cross-examination of key witnesses before the Bankruptcy Judge offers the Bank a meaningful opportunity to demonstrate its good faith in the matter. The Trustee is likely to argue that having already convinced the Bankruptcy Judge that it was entitled to summary judgment—arguably under a stricter evidentiary standard than would apply at trial—even a more fulsome trial record could not disturb the Bankruptcy Court's determination that the Bank was not entitled to a "good faith" defense.

For the prime brokerage industry, the District Court's decision is particularly worrisome because the Court rejected the broad public policy argument that the securities trading industry would be severely undermined if transferee liability is imposed on the basis of an industry-standard account agreement. The Court reasoned that brokers are not immune under the Bankruptcy Code and counsel advising prime brokers are free to redraft the standard industry account agreement to avoid transferee liability. The Court also noted that prime brokers retain "a robust 'good faith' defense to avoid liability." At a minimum, therefore, prime brokerage agreements need to be reviewed and revised, if feasible and practical, to take into account this ruling. Moreover, prime brokerage operations should also be reviewed in light of this ruling to assess how effective the existing oversight and compliance regimes would be in establishing a "good faith" defense if it were necessary to do so to preclude an avoidance action. It is a fair bet that for many prime brokerages, both documents and practices will need to be revised in light of this ruling.

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