Know Your Customer: Prime Broker Must Return All Margin Payments after Bankruptcy Court Finds That They Were Fraudulent Transfers

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The United States Bankruptcy Court for the Southern District of New York (Bankruptcy Court) recently issued a significant decision for securities firms and, in particular, for prime brokers. *See Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, __ B.R. __, Adv. Pro. No. 01-2606, 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007). In that decision, the Bankruptcy Court held Bear, Stearns Securities Corp. (Bear Stearns) liable to return, to the bankruptcy estate of a hedge fund that had engaged in a ponzi scheme, more than $125 million in margin payments that Bear Stearns had received from the fund before the fund had ceased operations. The Bankruptcy Court also required Bear Stearns to pay an additional $34 million in pre-judgment interest, imposing substantial liability even though Bear Stearns had earned only $2.4 million in fees from the hedge fund.

The decision is important not only because of the amount of money involved, but also because of the legal principles on which the Bankruptcy Court relied. Concluding that all payments made in a ponzi scheme are "fraudulent" by nature, the Bankruptcy Court found that the hedge fund had paid its margin debt to Bear Stearns with actual intent to hinder, delay or defraud its creditors, and that the payments were therefore "fraudulent transfers." Moreover, the Bankruptcy Court rejected the complete defense that fraudulent transfer law normally affords to the recipient of a fraudulent transfer that took the transfer for value and in "good faith." The Bankruptcy Court held that Bear Stearns was on "inquiry notice" that the hedge fund might be engaged in fraud and that Bear Stearns had not acted with sufficient "diligence" to satisfy the good faith standard.

Background

Bear Stearns functioned as the prime broker for Manhattan Investment Fund Ltd. (the Fund), a hedge fund that purported to make money by short selling technology stocks, but that actually falsified account records and perpetrated a massive ponzi scheme, using funds from new investors to cover its losses and to allow older investors to redeem their investments. In 1999, the Fund made 18 separate transfers totaling $141.4 million into its Bear Stearns margin account. The Fund eventually lost most of those monies—approximately $125 million—through its trading activities. An SEC investigation led to the appointment of a receiver, who caused the fund to file for relief under chapter 11 of the Bankruptcy Code. The receiver became the trustee of the Fund's bankruptcy estate.

The bankruptcy trustee brought a fraudulent transfer action against Bear Stearns that sought to recover the entire $125 million. Because of the so-called "stockbroker defense" to constructive fraudulent transfers,[i] the trustee could succeed in recovering the $125 million of margin payments from Bear Stearns only if she proved that the Fund made the transfers with actual intent to hinder, delay or defraud one or more of the Fund's present or future creditors.[ii] On this element, however, the Bankruptcy Court applied an absolute rule: "[T]ransfers made in the course of a ponzi operation could have been made for no purpose other than to hinder, delay or defraud creditors."[iii] Thus, the Bankruptcy Court held that, because the Fund had engaged in a ponzi scheme, all payments it had made to Bear Stearns satisfied the "actual intent" requirement.

To avoid liability for the fraudulent transfers, Bear Stearns had to prove that it took the payments "for value" and in "good faith."[iv] The Bankruptcy Code provides that a stockbroker or financial institution (like Bear Stearns) that receives margin payments (the payments made here) takes those payments "for value."[v] Thus, Bear Stearns held a complete defense to the trustee's fraudulent transfer claim if it could also prove that it took the margin payments in "good faith." Bear Stearns's good faith, therefore, became a key issue in the case.

The "Good Faith" Analysis

The Bankruptcy Court began its analysis by applying an "objective, reasonable man" standard for good faith that demanded more of Bear Stearns than simply acting without bad intent. According to the Bankruptcy Court, "'good faith' includes not only 'honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage' but also 'freedom from knowledge of circumstances which ought to put the holder on inquiry.'"[vi] Indeed, the Bankruptcy Court stressed that, in the bankruptcy context, "courts look to what the transferee objectively knew or should have known in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint," and that a transferee has not acted in good faith "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose."[vii]The Bankruptcy Court thus stressed that "a transferee may not remain willfully ignorant of facts that would otherwise cause it to be on notice of a debtor's fraudulent purpose."[viii]

The Bankruptcy Court applied this demanding legal standard to the facts at issue in the case. It found that in December 1998, a Bear Stearns representative learned at a cocktail party that the Fund was reporting 20% annualized profits to its investors, even though Bear Stearns's internal reports showed that the Fund was suffering losses in its Bear Stearns accounts. The Bear Stearns representative followed up with his boss and other colleagues, eventually leading to a conference call with the Fund's principal, Michael Berger (who later pled guilty to securities fraud and then fled the country), who represented—falsely—that Bear Stearns was only one of the Fund's eight or nine prime brokers, and that Bear Stearns's information did not reflect the Fund's position generally.

By August 1999, Bear Stearns was issuing margin calls almost on a daily basis to the Fund. The Fund continued to suffer substantial losses according to the records available to Bear Stearns.

In December 1999, another incident occurred when the Bear Stearns representative heard that the Fund had not paid money it owed to a marketer. In the view of the Bankruptcy Court, Bear Stearns then "finally took steps to determine what was really going on."[ix] It made inquiry on "the Street," and then with Mr. Berger directly, to determine which other institutions functioned as the Fund's prime brokers. Unsatisfied with the inconsistent and incomplete information it was provided, Bear Stearns signed a confidentiality agreement so that it could examine the Fund's financial statements. After a "ten-minute review," Bear Stearns knew a problem existed—the financial statements disclosed that the Fund primarily used only one prime broker (Bear Stearns), and that the Fund's disclosed equity was substantially greater than Bear Stearns's records showed it to be.[x] Bear Stearns then notified the SEC.

Given these facts, the Bankruptcy Court granted the bankruptcy trustee summary judgment, finding that "Bear Stearns cannot satisfy its burden of showing that it acted with the diligence required to establish good faith under section 548(c) of the Bankruptcy Code."[xi] The Bankruptcy Court found that Bear Stearns was on inquiry notice of Mr. Berger's fraud from its receipt of the first information at the cocktail party in December 1998. Bear Stearns did, in fact, make inquiry of Mr. Berger then. But, according to the Bankruptcy Court, "Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong."[xii] Rather, the "diligence" required by the "good faith" standard required Bear Stearns to consult "easily obtainable sources of information that would bear on the truth of any explanation received from the potential wrongdoer."[xiii]

Accordingly, the Bankruptcy Court entered judgment for the trustee, requiring Bear Stearns to pay back the entire $125 million plus $34 million in pre-judgment interest. Bear Stearns has appealed the decision.

The Bottom Line

As noted, the Bankruptcy Court's opinion is significant not only because it resulted in the imposition of such a large liability on a prime broker, but also because of the legal principles it applied to reach that result. Unless overturned on appeal, the decision suggests that prime brokers may need to engage in significant due diligence—at least if they become aware of "red flags" regarding any of their accounts—to insulate themselves from losses that could be quite substantial if the account holder subsequently goes into bankruptcy.

For more information on this or other bankruptcy and commercial matters, please contact the authors listed above.

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[i] *I* See 11 U.S.C. § 546(e).

[ii] *See* 11 U.S.C. § 548(a)(1)(A).

[iii] *In re Manhattan Investment Fund, Ltd.*, slip op. at 11.

[iv] *See* 11 U.S.C. § 548(c).

[v] *See* 11 U.S.C. § 548(d)(2)(b).

[vi] *In re Manhattan Investment Fund, Ltd.*, slip op. at 22 (quoted citations omitted).

[vii] *Id.* (quoted citations omitted).

[viii] Id.

[ix] Id. at 26.

[x] Id. at 27.

[xi] Id. at 28.

[xii] Id. at 27.

[xiii] Id.

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