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# District Court Upholds Bankruptcy Court Ruling That Prime Brokers Are Initial Transferees Under the Bankruptcy Code

New York
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On December 17, 2007, the United States District Court for the Southern District of New York upheld in part and reversed in part a decision by the Bankruptcy Court for the Southern District of New York that had found Bear Stearns Securities Corp. liable for the disgorgement of $141.4 million in margin payments it received from the Manhattan Investment Fund in the year before the Fund filed for bankruptcy. Bear Stearns Sec. Corp. v. Gredd, No. 07 Civ. 2511, slip op. (S.D.N.Y. Dec. 17, 2007) ("Bear Stearns"). While the District Court embraced most of the Bankruptcy Court's rulings, it found an issue of fact existed as to whether Bear Stearns had a valid good faith defense to the fraudulent conveyance claim, and remanded for a trial on that issue.

The key facts in this case are as follows: Bear Stearns was the prime broker for the Fund, a hedge fund which had incurred almost $400 million of losses in the late 1990s.[1] The Fund hid its losses by persuading new individuals to invest and using those funds to pay off existing investors.[2] Bear Stearns required the Fund to maintain a margin account to support its trading activity.[3] In the year prior to its bankruptcy, the Fund deposited $141.4 million into this account.[4] Following its bankruptcy filing, the Fund's Trustee sought to recover these funds from Bear Stearns, claiming that such margin payments constituted a fraudulent conveyance under section 548 of the Bankruptcy Code that should be returned to the estate for the benefit of the Funds' creditors.

1 Bear Stearns, slip op. at 3.

2 Id.

3 Id., at 4.

4 Id., at 5.

The primary issues decided by the Bankruptcy Court and reviewed by the District Court include: (a) whether the Fund's margin payments to Bear Stearns constituted fraudulent transfers under section 548 of the Bankruptcy Code; (b) whether Bear Stearns was an initial transferee or a mere conduit for the funds; and (c) whether Bear Stearns could avail itself of a good faith defense to the fraudulent conveyance claim.

**Fraudulent Transfers**: The District Court upheld the Bankruptcy Court's decision that the margin payments were made with actual intent to defraud the Fund's creditors, rejecting Bear Stearns' arguments that the transfers were not fraudulent because they did not place the monies outside the reach of the Funds' creditors and that the Trustee had not demonstrated the existence of a Ponzi scheme as a matter of law and fact.[5] In particular, the District Court reaffirmed the principle of law that in the case of a Ponzi scheme, actual fraud is presumed with respect to transfers of property by a debtor made in furtherance of the fraud, regardless of the transferee's knowledge of the fraud.[6] The District Court further concluded that in this case, the payment of the margin payments was in furtherance of the Fund's Ponzi scheme,[7] thereby satisfying the presumption of actual fraudulent intent.[8]

**Initial Transferee**: The District Court also upheld the Bankruptcy Court's decision that Bear Stearns was an initial transferee of the margin payments under section 550(a) of the Bankruptcy Code (rather than a mere conduit) because it exercised dominion over the funds. Even though Bear Stearns was not able to use the funds in the margin account to make a separate profit and did not have unfettered control over them,[9] Bear Stearns had certain control over the funds, including the power to use the funds to close out the Fund's short positions without its permission and to prevent the Fund from withdrawing money from the margin account.[10] The District Court was not persuaded by the concerns expressed by Bear Stearns and various amici that a finding of transferee liability on the basis of the powers conferred by the account agreement, which terms are standard in the industry, would make prime brokers less willing to stand behind the kind of short sales in which the Fund

[5] Id., at 13, 27.

[6] Id., at 21.

[7] Id., at 27.

[8] Id.

[9] Id., at 37.

[10] Id., at 40.

was engaged.[11] The District Court reasoned that the account agreements could be revised to reduce the level of control that prime brokers exercise over the funds in margin accounts, or prime brokers could rely on the good faith defense to avoid liability.[12]

**Good Faith Defense**: Most significantly, the District Court departed from the Bankruptcy Court's ruling by holding that, while Bear Stearns was on inquiry notice of the Fund's fraud, summary judgment was not appropriate on its good faith defense because genuine issues of material fact exist as to whether the actions undertaken "by Bear Stearns demonstrated diligence in its investigation of the Fund."[13] The District Court agreed with the Bankruptcy Court that Bear Stearns was put on inquiry notice of the Fund's fraud beginning in December 1998 when a Bear Stearns employee learned of the Fund's reported performance at a cocktail party, which differed significantly from his understanding based on the performance of investments held in accounts at Bear Stearns.[14]

The District Court could not conclude as a matter of law, however, that Bear Stearns was not entitled to assert a good faith defense given the investigation into the Fund that Bear Stearns engaged in during and after December 1998. In particular, the District Court concluded that a question remained as to whether Bear Stearns' inquiry was sufficiently diligent under the circumstances. Among the factors considered by the District Court was the fact that prime brokers are not charged with "know-your-customer" responsibilities where, as here, an introducing broker was involved.[15] The District Court remanded the case back to the Bankruptcy Court for trial on this issue.

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[11] Id., at 48.

[12] Id., at 49.

[13] Id., at 58.

[14] Id., at 51-52.

[15] Id., at 57.

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