Hurdles Trustees Face in Asserting Fraudulent-Transfer Claims Against Brokers in Short-Sales

Written by:
Brian A. Abramson
Diamond McCarthy LLP; Houston
babramson@diamondmccarthy.com

Kyung S. Lee
Diamond McCarthy LLP; Houston
klee@diamondmccarthy.com

About the Authors

Brian Abramson is an associate and Kyung Lee is a partner at Diamond McCarthy LLP in Houston.

Feature

As more fraudulent financial schemes are exposed and forced into bankruptcy, the trustee (or, in other circumstances, possibly a debtor-in-possession or the committee of unsecured creditors) assigned the role of recovering estate assets is often asked to evaluate the viability of asserting Bankruptcy Code chapter 5 causes of action against financial institutions that served a variety of roles within these flawed arrangements.

Brian A. Abramson

One particular avenue trustees must often consider involves the merits of fraudulent-transfer claims against brokerage firms (hereinafter, "brokers") who participated in (and often facilitated) short-sale transactions within the investment scheme. As defined in *Manhattan Investment Fund,* one of the most recent cases assessing this type of claim, "[a] short sale is a speculative transaction where a security not owned by the seller is sold in the hope that the price of the security will decline, permitting the seller to later repurchase the security ('cover') and make a profit. Typically, the seller borrows the security to be sold short from his broker and covers by later buying the identical stock and transferring it to his broker."[1]

Generally, brokers involved in these transactions serve as the source of the stock sold short by the investment scheme (*i.e.,* the brokers pay for securities purchased by the debtor and deliver securities sold by the debtor). To support trading activity, the debtor is required to maintain a margin account with a specifically-required balance and, therefore, the debtors periodically make "margin payments" to ensure the continuation of this account and the investment scheme. Accordingly, such fraudulent-transfer claims would likely be targeted at avoiding the margin payments received by the brokers.

Kyung S. Lee

For example, in *Manhattan Investment Fund,* Bear Stearns acted as the debtor's broker to facilitate the debtor's short sale activities, and the debtor maintained a margin account with Bear Stearns.[2] In the one year immediately preceding the debtor's bankruptcy filing, the debtor made 18 margin payments totaling $141.1 million to its margin account with Bear Stearns.[3] The trustee's fraudulent-transfer claims against Bear Stearns were aimed at avoiding these particular margin payments.

At first glance, such claims provide immediate appeal to trustees looking to recover seemingly evaporated funds because they often involve large damage models against (generally speaking) solvent entities. Nevertheless, a closer look at these claims demonstrates that, before diving into this "pot of gold," trustees should recognize the significant legal and factual hurdles they will encounter in their recovery efforts.

This article focuses on the three primary hurdles that trustees administering the bankruptcy estates of exposed fraudulent financial schemes face upon asserting fraudulent-transfer claims against brokers involved in short-sale transactions. The discussion below provides a roadmap for trustees to best navigate through—and potentially overcome—each hurdle. These hurdles are (1) establishing actual intent, (2) demonstrating that the broker was an initial transferee and (3) overcoming the good-faith defense.

Hurdle #1: The Actual-Intent Requirement and the Ponzi Scheme Presumption

When fraudulent transfer claims are brought against brokers,[4] trustees are limited to asserting actual-intent fraudulent-transfer claims under §548(a)(1)(A) of the Bankruptcy Code. Accordingly, the first hurdle trustees must overcome is establishing the debtor's actual intent to hinder, delay or defraud. The claim of actual fraud looks only to the fraudulent intent of the debtor-transferor (the "debtor") and does not require the trustee to allege or prove that the transferee had any intent to hinder, delay or defraud or had any knowledge of the debtor's fraudulent intent.[5]

Establishing actual intent often entails a prolonged fact-intensive inquiry. However, to assist the plaintiff in the fraudulent-investment-scheme context, courts have fashioned a presumption that when a plaintiff establishes the debtor's operation as a Ponzi scheme, the debtor's actual intent to hinder, delay or defraud its creditors is established as a matter of law.[6] However, for the presumption to apply, the trustee must satisfy the burden that the investment scheme in question could only serve to defraud investors and, therefore, is a qualifying Ponzi scheme.[7] In the absence of this presumption, the trustee must rely on circumstantial evidence of fraudulent intent to establish its claim.

1 397 B.R. 1, 3 n.3 (S.D.N.Y. 2007).

2 359 B.R. 510, 513-15 (Bankr. S.D.N.Y. 2007).

3 *Id.*

4 Bankruptcy Code §546(e) (the stockbroker exception) provides a safe harbor that shields margin payments from avoidance notwithstanding §§544, 545, 547 and 548(a)(1)(B) (constructive-intent fraudulent-transfer claims) and 548(b). 11 U.S.C. §546(e). However, this exception does not apply when the debtor makes such payments with actual intent to defraud other creditors. *See* 11 U.S.C. §546(e) (not including §548(a)(1)(A) in exception).

5 *In re Bayou Group LLC,* 362 B.R. 624, 631 (Bankr. S.D.N.Y. 2007).

6 *Id.* at 633.

7 *Id.*

In addition to situations in which the debtor admits to operating a Ponzi scheme or is found criminally liable for fraud,[8] several decisions have applied the Ponzi scheme label and presumption to any sort of inherently fraudulent arrangement under which the debtor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.[9] Nevertheless, it is unlikely that the presumption will apply in every case of Ponzi-type investment arrangements, meaning that the trustee will often be tasked with establishing that the scheme could only serve to defraud investors.

Moreover, because fraudulent-transfer claims against brokers concern funds transferred to a financial institution rather than to investors, a trustee arguing for application of the Ponzi scheme presumption may also need to demonstrate that the transfers were related to, or made to, further the Ponzi scheme.[10] If the Ponzi scheme involved short-sale activities and margin payments, this argument should prevail because transfers into margin accounts are necessary to keep the debtor operational and alive (*i.e.*, the financial institution would have closed out its short positions and used the money in the account to cover its own liabilities if the transfers were not made).[11] Here are some key questions to consider when attempting to overcome the first hurdle.

- Was the debtor's investment arrangement a Ponzi scheme?
  - Was the debtor's investment program connected to any legitimate business operation or an operation that was significantly overleveraged?
  - Did the debtor make highly unrealistic promises to investors?
  - Did the debtor become grossly overextended within a short period of time?
  - Has the debtor admitted to operating a Ponzi scheme or been found criminally liable for fraud?
  - Was the debtor involved in an arrangement under which the debtor had to utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud?
- If there was a Ponzi scheme, were transfers to the broker related to, or made in furtherance, of the Ponzi scheme?
- If there was no Ponzi scheme, did the debtor otherwise transfer or incur an obligation with actual intent to hinder, delay or defraud?

Hurdle #2: The Initial Transferee Quandary

Since we are assessing the viability of claims against brokers and not investors, after establishing the debtor's actual intent, the trustee will almost certainly be required to establish that the broker was an initial transferee under §550(a) of the Code, rather than a mere conduit or intermediary that cannot be held liable for the recovery of damages for fraudulent-transfer claims.

The meaning of "transferee" has developed through case law because the Code "does not define 'transferee' and there is no legislative history on the point."[12] Most circuits analyzing this issue have adopted the "dominion and control" test (the "mere conduit" test) to determine transferee liability under §550.[13] Under this test, "the minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes. When A gives a check to B as agent for C, then C is the 'initial transferee;' the agent may be disregarded."[14] The "dominion and control" test seeks to ensure that the term "initial transferee" means something more than "initial recipient," "the passing of mere possession" or "the first hands to touch the asset."[15]

In applying the "dominion and control" test, the transferee status is measured at the time of the transfer (*i.e.*, receipt of the transfer), and not based on subsequent events. Moreover, the test turns on the recipient's legal rights and obligations toward the transferred assets, not simply the recipient's legal relationship with the debtor or the ultimate use of the assets.

Based on *dicta* from Hon. Frank Easterbrook in *Bonded Financial Services*, brokers facing fraudulent-transfer claims might argue that the recipient must have "unfettered control" over the funds.[16] The *Manhattan Investment Fund* courts disagreed with this argument, holding that legal restrictions on the use to which transferred funds can be put merely limits how the recipient will exercise its dominion over the funds; they do not preclude the recipient from having dominion at all.[17]

Nevertheless, financial institutions are not typically deemed to be initial transferees because the funds are merely passing through their accounts to a third party, and the broker has no dominion or control over the pass-through funds.[18] Financial institutions are generally deemed mere conduits of a customer's deposits.

Moreover, brokers facing claims in this context will almost certainly argue that Rule 15c3-3 (the Customer Protection Rule) of the Securities and Exchange Commission (SEC) expressly precludes a conclusion that the broker has dominion and control over the transferred funds and requires brokers to maintain a strict separation between its proprietary activities and customer assets. Accordingly, brokers are arguably expressly precluded from using any monies in the account for purposes unrelated to the debtor's trading. Some have alleged that Rule 15c3-3's express prohibition is sufficient on its face to conclude that a broker subject to the rule lacks the requisite dominion and control to be a transferee.

Finally, trustees asserting claims against the broker should expect to face certain public policy arguments from not only the broker, but also interested securities boards and commissions. For example, as set forth by the SEC in its *amicus* brief to the Second Circuit in *Manhattan Investment Fund*, these public policy arguments will likely be focused on the alleged disproportionate potential liability faced by brokers compared with the financial gains they actually earn in this role.[19]

Notwithstanding these legal and public policy arguments, *Manhattan Investment Fund* demonstrates that courts may deem brokers involved in

8 *See, e.g.*, *Scholes v. Lehmann*, 56 F.3d 750, 762 (7th Cir. 1995).
9 *In re Bayou Group*, 362 B.R. at 633; *In re Agric. Research and Tech. Group Inc.*, 916 F.2d 528, 536 (9th Cir. 1990).
10 *In re Manhattan Inv. Fund*, 397 B.R. at 10-13.
11 *Id.*
12 *Bonded Fin. Svcs. Inc. v. European Am. Bank*, 838 F.2d 890, 893 (7th Cir. 1988).
13 *Id. See In re Manhattan Inv. Fund*, 397 B.R. at 16 (regarding Second Circuit); *In re Incomnet Inc.*, 463 F.3d 1064 (9th Cir. 2006) (regarding Ninth Circuit).
14 *Bonded Fin. Svcs.*, 838 F.2d at 893.
15 *In re Finley*, 130 F.3d 52, 56-59 (2d Cir. 1997).
16 838 F.2d at 893-94 (noting that initial transferee has right to "buy lottery tickets or uranium stocks").
17 *In re Manhattan Inv. Fund*, 397 B.R. at 16; In re Manhattan Inv. Fund, 359 B.R. at 521-22.
18 *See, e.g.*, *In re First Sec. Mortgage Co.*, 33 F.3d 42, 44 (10th Cir. 1994).
19 SEC brief, *amicus curiae*, in support of Defendant-Cross-Appellant at 26-28.

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short-selling and margin payments to be distinguishable from general "mere conduit" cases, regardless of Rule 15c3-3 or public policy.[20]

Specifically, the bankruptcy court and district court held that, pursuant to the brokerage agreement at issue and an analysis of the operations of the relationship between the debtor and Bear Stearns, Bear Stearns' short-selling and margin payments involved a sufficient level of dominion and control over the transferred funds (although not unfettered) to render Bear Stearns an initial transferee.[21] Based on this holding, the initial-transferee analysis in the Ponzi scheme context likely hinges on a fact-intensive inquiry focused on the relationship between the broker at issue and the assets transferred. Here are some key questions to consider when attempting to overcome the second hurdle.

[20] The appeal in *Manhattan Investment Fund* was decided in June 2009. 328 Fed. Appx. 709 (2d Cir. 2009). After affirming the district court's opinion on the good-faith defense inquiry (discussed more fully in hurdle number three), the Second Circuit expressly declined to reach the issue of whether Bear Stearns was an initial transferee. *Id.* at 710-11.

[21] *In re Manhattan Inv. Fund*, 397 B.R. at 16-22; *In re Manhattan Inv. Fund*, 359 B.R. at 521-22.

- Did the broker receive compensation for its services as broker (*e.g.*, fees for brokerage services or commissions)?
- Did the broker face potential liability if the transfers were not made?
- What were the terms of the debtor's account agreement with the broker, and were the terms structured to ensure that monies transferred would be available to protect the broker's economic interests?
- Once the transferred funds were deposited with the broker, did the broker have any obligation to respond to the debtor while short positions were open?
- Was the broker authorized to use transferred funds to make a separate profit or for any other proprietary activities?
- Could the broker make decisions regarding transferred funds once they were in the debtor's account with the broker and, if so, what types of decisions could be made?
- Could and did the broker raise or adjust the debtor's required margin levels?
- Were there legal or contractual restrictions placed by the debtor on the broker's use of transferred funds?
- Did the broker use transferred funds to satisfy a pre-existing debt or an obligation it had elsewhere?
- Were there open short positions in the debtor's account with the broker when each transfer was made to the broker?
- Did the debtor ever seek to rescind the terms of the account agreement or close out its short positions?
- Did the broker produce reports (over any timeframe) to assess whether the debtor posed a risk to the broker's capital?
- To the extent that the broker held a security interest in funds held in the debtor's account, did the broker ever exercise its security-interest rights?

Hurdle #3: A Good-Faith Defense

After the trustee satisfies its burdens that the debtor acted with actual intent and the broker was in fact an initial transferee, the trustee will almost certainly have to contend with the broker's defense of good faith. The

good-faith defense under §548(c) of the Code provides the broker with a statutory opportunity to overcome the trustee's demonstration of actual intent. The good-faith defense is an affirmative defense, and the burden is on the broker to plead and establish facts to prove the defense.[22] Courts have held that the good-faith inquiry in the actual-intent fraudulent-transfer context is an objective one: the duty of care that must be exercised is that of a reasonable person.[23]

The broker, therefore, cannot meet this burden by merely proving that it did not have any actual, subjective knowledge that the debtor was operating a Ponzi scheme. The broker must also establish that there were no facts surrounding its dealings with the debtor to put it on inquiry notice of the debtor's fraud or insolvency.[24] If the broker knew or should have known that the debtor's investment scheme was too good to be true, then the broker has failed to carry the burden of proving that it accepted sums from the debtor in good faith, and the trustee is prospectively entitled to recover all amounts the broker received from the debtor.[25]

The good-faith defense to an actual-intent fraudulent-transfer claim will likely also involve an analysis of the sufficiency of the broker's due-diligence investigation. Because the trustee's claims against brokers in the short-sale transaction context often involve more than one margin payment, there may be a dispute regarding the period in time in which due diligence was exhibited by the broker. Specifically, when the claims involve multiple transfers, questions may arise regarding whether a broker already on inquiry notice could nonetheless take transfers in good faith even if it was still in the process of determining whether the debtor was engaged in fraud, but had yet to complete its investigation.

In *Manhattan Investment Fund*, one of the central appellate issues concerned the district court's jury instruction regarding the good-faith defense, including when good faith should be assessed and the status of the broker's due diligence at the time of the transfers. On appeal, the trustee argued that if Bear Stearns was on inquiry notice of fraud, the requisite due diligence inquiry had to be *completed* prior to accepting any of the transfers (*i.e.*, with respect to each specific transfer, there needed to be a showing that the financial institution's requisite due diligence inquiry was completed, not ongoing, prior to accepting the particular transfer).[26]

Bear Stearns' relevant substantive response was that the good-faith defense should be determined on a case-by-case basis, and when evaluating multiple transfers, courts evaluate good faith over a period of time.[27] Although the issue in *Manhattan Investment Fund* was focused more on whether the jury instruction constituted harmless error, if there are multiple transfers at issue (as is likely with these types of claims), the trustee should be cognizant of the due-diligence efforts made by the broker throughout the history of the transfers, including before the first transfer, during the series of transfers, and even potentially after the final transfer.[28]

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While there are certain factors courts generally apply in assessing the objective good-faith standard to actual-intent fraudulent-transfer claims,[29] the questions below are specifically tailored to considerations for a trustee asserting claims against brokers, not ordinary investors.

- Did the broker have a high level of business knowledge and experience in the area of short-sale transactions?
- Does the broker have experience conducting investigations into similar types of short sale transactions?
- Did the broker actually know or suspect that the debtor was operating a fraudulent scheme?
- Did circumstances arise to put the broker on inquiry notice of the debtor's scheme, and when did such circumstances arise?
- What type of due diligence investigation did the broker make of the debtor's investment scheme?
  - When did the debtor's investigation commence?
  - When multiple transfers are involved, was the broker diligent in its inquiry throughout the time the funds were being transferred?
  - Were readily available documents obtained and examined by the broker?
  - Was the investigation independent or did it rely on reports of third parties?
- Did the broker conduct a sufficient inquiry to persuade a reasonable person that there was no fraud with the debtor's scheme?
- Was there a discrepancy between the debtor's reported performance and its performance to the broker, and if so, when did this occur and when was it discovered by the broker?
- Was an audit performed by the broker (or otherwise) on the debtor's assets, and if so, when did this occur and what did it uncover?
- Did the broker receive inquiries from investors questioning the accuracy of the debtor's performance?
- What types of information or documents did the broker receive regarding the debtor or the debtor's scheme, and how did the broker respond to receipt of such information or documents?

Conclusion

This article highlights and may provide a useful guide to the various arguments, defenses and questions that must be fully vetted in the assessment of fraudulent-transfer claims against brokers involved in short-sale transactions. This article is not intended to provide a recitation of why such claims are unlikely to succeed. Rather, for trustees tasked with administering the estates of fraudulent financial schemes, such claims may well exist and potentially provide significant recovery for creditors. ■

22 *In re Bayou Group*, 362 B.R. at 631.

23 *In re Lake States Commodities Inc.*, 253 B.R. 866, 878 (Bankr. N.D. Ill. 2000).

24 *Id.*

25 *Id.* at 879.

26 Brief for Plaintiff-Appellant-Cross-Appellee at 43-45.

27 Brief for Defendant-Appellee-Cross-Appellant at 34-36.

28 The Second Circuit affirmed the district court's opinion, holding "we cannot say that the district court's jury instructions misled the jury as to the correct legal standard or did not adequately inform the jury of the law." 328 Fed. Appx. at 710.

29 *See In re M & L Bus. Mach. Co.*, 84 F.3d 1330, 1332 (10th Cir. 1996).