**UNITED STATES DISTRICT COURT**
**SOUTHERN DISTRICT OF NEW YORK**

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| In re | : | |
| | : | |
| MANHATTAN INVESTMENT FUND LTD., | : | 00-10922 (BRL) |
| et al., | : | 00-10921 (BRL) |
| | : | |
| Debtors. | : | Jointly Administered |
| BEAR, STEARNS SECURITIES CORP., | : | |
| | : | Adv. Pro. 01-02606 |
| Defendant-Appellant, | : | |
| Cross-Appellee, | : | Civil Action No. 07-02511 (NRB) |
| vs. | : | |
| | : | |
| HELEN GREDD, Chapter 11 Trustee for | : | |
| MANHATTAN INVESTMENT FUND LTD., | : | |
| | : | |
| Plaintiff-Appellee, | : | |
| Cross-Appellant. | : | |

# BRIEF OF INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. AND FINANCIAL MARKETS LAWYERS GROUP AS *AMICI CURIAE* IN SUPPORT OF DEFENDANT-APPELLANT AND REVERSAL

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The International Swaps and Derivatives Association, Inc. ("ISDA") and Financial Markets Lawyers Group ("FMLG") respectfully submit this brief as *amici curiae* in support of the appeal of Bear, Stearns Securities Corp. ("Bear Stearns") from the judgment of the United States Bankruptcy Court for the Southern District of New York (Lifland, J.) (the "Bankruptcy Court") dated February 21, 2007, in favor of Helen Gredd, Chapter 11 Trustee (the "Trustee") for the Manhattan Investment Fund Ltd. (the "Fund").

## PRELIMINARY STATEMENT

Bear Stearns was the Fund's prime broker. In that capacity, Bear Stearns cleared and facilitated billions of dollars of securities trades for the Fund over several years, in exchange for which Bear Stearns was paid fees totaling approximately $2.4 million. Although the Fund's principal was apparently misrepresenting the Fund's performance to investors, a lawsuit claiming that Bear Stearns aided and abetted that alleged fraud was dismissed at the pleading stage. *Cromer Finance Ltd.* v. *Berger*, 137 F. Supp. 2d 452, 469-72 (S.D.N.Y. 2001).

In the decision below, the Bankruptcy Court held that Bear Stearns, despite its non-participation in the Fund's fraud, is liable to the Fund's creditors for approximately $125 million (together with prejudgment interest, $159 million)—representing the total of 18 different amounts that the Fund deposited into its own brokerage account, and then lost in the stock market, during the year prior to the Fund's bankruptcy filing (the "Deposits"). *Gredd* v. *Bear, Stearns Sec. Corp*. (*In re Manhattan Inv. Fund Ltd.*), 359 B.R. 510, 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007) ("*Gredd II*"). Although the Fund's trading activities were legitimately intended to be profitable and were consistent with the investment approach disclosed to its investors, the Bankruptcy Court concluded that the Fund was conducting a Ponzi scheme (in which Bear Stearns had no role); as a result, the Bankruptcy Court found that *all* of the Fund's transfers, including its Deposits into its own account, were presumptively intended to defraud creditors. *Id*. at *4-5. The Bankruptcy Court further concluded that Bear Stearns is strictly liable for those Deposits as their "initial transferee." According to the Bankruptcy Court, Bear Stearns had "dominion and control" over the Deposits—a precondition for "initial transferee" liability—even though Bear Stearns received the Deposits solely as the Fund's intermediary, and with no ability to use them for its own proprietary purposes. *Id*. at *6-9.

ISDA and FMLG have come before the Court as *amici curiae* because they believe that the imposition of fraudulent transfer liability on financial intermediaries such as Bear Stearns would extend the reach of fraudulent transfer law far beyond its established limits and, as a result, endanger the health of the financial markets, including the derivatives, foreign exchange, and swaps markets. The principles on which ISDA and FMLG rely are familiar to this Court. In rejecting the Trustee's attempt to recover from Bear Stearns both the proceeds of the Fund's short sales during the year prior to its bankruptcy filing ($1.7 billion) and the securities purchased to cover those short sales ($1.9 billion), this Court previously recognized that fraudulent transfer law is fundamentally about protecting creditors from harm. *Bear*, *Stearns Sec. Corp.* v. *Gredd*, 275 B.R. 190, 195 (S.D.N.Y. 2002) ("*Gredd I*") ("[T]he overarching purpose of the Bankruptcy Code . . . requires the fraudulent transfer to have actually harmed at least one creditor."). Consequently, in *Gredd I*, this Court held that the transfers of $1.7 billion in sale proceeds and $1.9 billion in covering securities were *not* avoidable, because federal law prohibited the use of those assets to pay the Fund's creditors. *Id*. at 198-99.

The Deposits at issue on this appeal likewise worked no harm upon the Fund's creditors, but for an opposite reason. Whereas the property at issue in *Gredd I* was never available to satisfy the Fund's creditors, because federal law required that it be used to cover the Fund's short positions, the property at issue in this case was available to satisfy the Fund's creditors both before and after the Deposits were made. The Deposits were no more than transfers of the Fund's own money from one "pocket" (a Fund account at Bank of Bermuda) to another (the Fund's brokerage account at Bear Stearns). *See Gredd II*, 2007 WL 60843, at *2. The Fund and its creditors were not harmed by any of those transfers, but rather by the Fund's own unprofitable (but authorized) trading activities, which ultimately required the Fund to cover its short positions at a huge loss.

The conclusion that a deposit into an account with a financial intermediary does not harm creditors, and therefore is not a fraudulent transfer, has deep support in the case law applying section 550(a) of Title 11 of the United States Code (the "Bankruptcy Code"), which imposes liability for a fraudulent transfer upon its "initial transferee." Under that law, the fact that the Deposits remained in the Fund's account and under its control, and were potentially accessible to Bear Stearns only to the extent necessary to protect Bear Stearns' position as a financial intermediary, means that the Fund, as opposed to Bear Stearns, had "dominion and control" over the Deposits. Bear Stearns, therefore, was not an "initial transferee" of the Deposits, and the Fund's creditor-investors are not entitled to recover from Bear Stearns.

In contravention of established law and bankruptcy policy, the Trustee has sought to create an unprecedented rule under which financial intermediaries—having made none of the investment decisions, and having no liability for fraud—can be held liable for their customers' trading losses. This Court should decline the Trustee's invitation to reallocate the risks associated with investing in a hedge fund from its investors to its financial intermediaries. Instead, this Court should reverse the judgment of the Bankruptcy Court on the basis that Bear Stearns was not an "initial transferee" of the Deposits.

## STATEMENT OF INTEREST

ISDA is the largest financial trade association in the world, representing leading participants in the privately negotiated derivatives industry. It was chartered in 1985, and includes more than 780 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in, and are leading end-users of, privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments is the standardization of derivatives documentation through the promulgation of ISDA Master Agreements. Today, ISDA Master Agreements serve as the contractual foundation for more than 90% of derivatives transactions globally.

FMLG is a group sponsored by but independent of the Federal Reserve Bank of New York, and is composed of lawyers who support foreign exchange and other financial markets trading in leading worldwide financial institutions. FMLG's objectives include: compiling trade documentation, offering best practices recommendations, and submitting legal briefs, comment letters, and policy papers relating to financial market developments. Along with the Foreign Exchange Committee, another group sponsored by but independent of the Federal Reserve Bank of New York, FMLG recently compiled the FX Master Give-Up Agreement, an agreement that documents the relationship between a dealer that executes a foreign exchange transaction and a prime broker whose client has directed that the transaction be executed.

As leading industry groups whose members include financial intermediaries, their customers, and lawyers that support financial markets trading, ISDA and FMLG have a strong interest in this appeal. If a financial intermediary's contingent right to use customer funds to avoid depletion of its own capital were sufficient to transform the intermediary into an "initial transferee" under fraudulent transfer law, financial intermediaries could be subjected to liabilities that not only vastly exceed the comparatively small fees earned from their customers' trades, but could even exceed their own proprietary firm capital. Indeed, under the ruling below, the only limit on a broker's potential fraudulent transfer liability would be the full amount of its customer's trading losses during the applicable reach-back period. While in this case those losses approximated $125 million, in another case they could potentially amount to $1 billion, $5 billion, or more.

Allowing hedge fund investors to recover their trading losses from the fund's intermediary would not only expose intermediaries to practically unlimited liability, but would also grant those investors an unjustified windfall. Investors in a hedge fund do not bargain for a guarantee from the fund's broker against losses resulting from the hedge fund's primary business activity—*i.e.*, investing in the securities markets. If such a retroactive guarantee went into effect upon a fund's bankruptcy filing, brokers would be unwilling to service customers whose financial stability is subject to doubt. Moreover, because the guarantee would be triggered by a showing that a broker could have discovered its customer's wrongdoing, brokers would have no choice but to monitor closely their customers' investment activities and reporting. Non-bankruptcy law imposes no such duty on prime brokers or custodians "to monitor, verify, or investigate the veracity of the information disseminated by" a hedge fund manager to its investors. *Pension Comm. of Univ. of Montreal Pension Plan* v. *Banc of America Sec., LLC*, 446 F. Supp. 2d 163, 202-03 (S.D.N.Y. 2006); *see also* N.Y.U.C.C. § 8-102(a) cmt. 10 ("[I]t would impair rather than advance the interest of investors in having a sound and efficient securities clearance and settlement system to require intermediaries to investigate the propriety of the transactions they are processing."). If bankruptcy law were interpreted to impose such a duty, the enormous resulting costs would have to be passed on to customers, to the extent possible, in the form of substantially increased fees. ISDA's members, therefore, along with clients of FMLG's members, will necessarily bear the brunt of the Bankruptcy Court's erroneous decision—whether they act as financial intermediaries or as customers of such intermediaries.

## THE PRIME BROKERAGE RELATIONSHIP

Prime brokerage refers to an arrangement between traders and broker-dealers to facilitate the clearance and settlement of securities and derivatives trades. In a prime brokerage relationship, a customer executes trades with different broker-dealers but clears the trades through one or more "prime brokers." The prime broker also functions as a custodian of the customer's securities, funds, and positions. *See* Gerald T. Lins, *et al.*, *Hedge Funds and Other Private Funds: Regulation and Compliance* § 2.3 (2006). In addition to clearing trades and holding assets in customer accounts, prime brokers at times help to facilitate trades for their customers. For example, the Fund used short sales heavily in its trading strategy. To effect a short sale, a hedge fund will borrow securities through its broker and sell them to a third party. At that time, the prime broker either lends the securities out of its own "inventory," or locates another party from which to borrow the securities. Ultimately, when the customer is required to "cover" its short sale, it will purchase, at the then-current market price, the same quantity of securities that it previously sold short, and return those securities to the prime broker or other lender. If the securities have declined in value, the customer profits by re-purchasing them for less than the price at which it had sold them short; conversely, if the securities have increased in value, the customer incurs a loss by re-purchasing the securities for more than the price at which it had sold them short. *See id.*; *see also* R. 102, at 18.[1]

The property held in a prime brokerage account is the subject of extensive regulation. Under the SEC's "Customer Protection Rule," a prime broker is prohibited from using a customer deposit for any purpose other than customer transactions. *See* 17 C.F.R.

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[1] References to "R. _" are to the Record on Appeal filed March 27, 2007 (Docket No. 2).

§ 240.15c3-3(e)(2). If a customer wishes to engage in short-selling, Federal Reserve Regulation T requires the customer to deposit into its margin account at least 50% of the value of the securities to be sold short, in addition to the cash proceeds generated by the short sale of the borrowed stock. *See Gredd I*, 275 B.R. at 197 (citing 12 C.F.R. § 220.12(c)(1)). By requiring a customer to maintain enough margin in its brokerage account to purchase the securities needed to cover its short positions, the margin rules protect the broker from having to use its own capital for that purpose. Together with the Customer Protection Rule, the margin requirements ensure that the prime broker's relationship to its customer is precisely that of an *intermediary*: The broker cannot use its customer's funds for its own proprietary purposes, but at the same time the broker is protected against having to put its own capital at risk as a result of the customer's trading activity.

Prime brokers further protect their intermediary position by contract. Here, Bear Stearns and the Fund entered into a "Professional Account Agreement" (R. 99, Ex. 63) (the "Account Agreement"), which, *inter alia*, (i) granted security interests to Bear Stearns that permitted Bear Stearns to apply the Fund's property to satisfy outstanding liabilities to Bear Stearns (§ 3); (ii) permitted Bear Stearns to close out the Fund's short positions or liquidate its long positions as necessary for Bear Stearns' protection (§ 5); and (iii) required the Fund to deposit the required margin in its customer account and pay any debit balances owing under its margin accounts (§ 17).[2]

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[2] Bear Stearns exercised some of its contract rights during the last year of the Fund's operations. However, because the Fund was always able to meet its covering obligations with its own funds, Bear Stearns never had to dip into its own capital to meet obligations incurred as an intermediary for the Fund. R. 95 at 2, 8.

Other than approximately $16.3 million that remained in the Fund's brokerage account and was returned to the Trustee by Bear Stearns, the Fund lost all of the other amounts deposited with Bear Stearns through its trading in the securities markets. The parties who benefited from the Fund's losses were the independent market participants who bought the stocks sold short by the Fund, and who profited as a result of those stocks' ultimate appreciation in value. Bear Stearns, by contrast, received nothing other than its brokerage fees, which totaled just $2.4 million for executing billions of dollars worth of securities transactions for the Fund from 1996 to 2000. *See Gredd I*, 275 B.R. at 191-92; *Gredd II*, 2007 WL 60843, at *3. Nonetheless, the judgment below would require Bear Stearns to pay to the Trustee, for the principal benefit of the Fund's investors, the full amount deposited in the Fund's account within a year of its bankruptcy filing ($141.4 million), less the amounts remaining in the Fund's account and returned to the Trustee by Bear Stearns ($16.3 million), plus prejudgment interest. *See Gredd* v. *Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, Adv. No. 01-2606, 2007 WL 534547, at *2 (Bankr. S.D.N.Y. Feb. 15, 2007) (entering judgment for the Trustee).

## ARGUMENT

To recover a fraudulent transfer, a plaintiff must establish that its alleged recipient was a "transferee" under section 550(a) of the Bankruptcy Code:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a). The Bankruptcy Court held that Bear Stearns was the "initial transferee" of the Fund's Deposits into the Fund's own brokerage account. That decision departs from well-settled law, and should be reversed.

The purpose of fraudulent transfer law is to prevent diminution of the pool of assets to which creditors may fairly look as a source for payment on their claims. In other words, there is no fraudulent transfer if the property remains available to satisfy creditor claims after the transfer. Given this purpose, the courts have uniformly held that "initial transferee" liability may only be imposed on a person that has taken "dominion and control" over estate property; by contrast, if the debtor maintains "dominion and control" over transferred property, there is no basis for fraudulent transfer liability or recovery, because creditors have not been harmed.

Here, the Fund alone maintained "dominion and control" over the Deposits as and after they were made. The Deposits did not deplete the estate assets available to satisfy the Fund's obligations and, therefore, did not harm the Fund's creditors. Bear Stearns, on the other hand, did not assume "dominion and control" over the Deposits for at least two reasons: (i) Bear Stearns could not use the Deposits for its own proprietary purposes, and (ii) to the extent that it had access to the deposited funds, Bear Stearns could do no more than protect its intermediary status by covering trades made at the Fund's direction. Since "dominion and control" over the Deposits never passed from the Fund to Bear Stearns, the Bankruptcy Court's determination that Bear Stearns was the "initial transferee" of the Deposits was erroneous as a matter of law.

## I. THE LIMITS OF INITIAL TRANSFEREE LIABILITY

The correct outcome in this case—judgment in favor of Bear Stearns—follows from (a) the basic principle that fraudulent transfer law requires an unjust diminution of the debtor's estate, and (b) the application of that principle to section 550(a)(1) of the Bankruptcy Code, which imposes liability for a fraudulent transfer on its "initial transferee." The requirement of unjust diminution, as given effect in cases interpreting section 550(a)(1), dictates that liability may be imposed on Bear Stearns only if "dominion and control" over the Deposits was passed from the Fund and its creditors to Bear Stearns. It plainly was not.

### A. The Requirement of Unjust Diminution

"The real test of a fraudulent conveyance . . . is the unjust diminution of the estate." 1 Garrard Glenn, *Fraudulent Conveyances and Preferences* § 195, at 348 (rev. ed. 1940); *accord*, *e.g.*, *In re First Alliance Mortgage Co*., 471 F.3d 977, 1008 (9th Cir. 2006). Based on this longstanding principle, this Court and numerous others agree that "creditors must actually be harmed in order to avoid a fraudulent transfer." *See Gredd I*, 275 B.R. at 194-95 (citing numerous cases). Diminution of the estate is an essential element of a fraudulent transfer regardless of whether actual intent fraud is alleged: "A transfer of property, *even if made with fraudulent intent*, that does not leave any creditor in a worse position than he would have been had the transfer never occurred, obviously does not offend the policy behind § 548(a)(1)(A) [the Bankruptcy Code's actual intent fraudulent transfer provision]." *Id*. at 195 (emphasis added).

In *Gredd I*, the assets allegedly transferred to Bear Stearns—the proceeds of the Fund's short sales ($1.7 billion), and the cost of the securities later purchased to cover those short sales ($1.9 billion)—were permitted under federal securities law to be used *only* to cover short sales. *Id*. at 197-99. Because "the transferred assets were never available to any creditors [of the Fund] by operation of federal law, and, therefore, the creditors suffered no harm," the funds in question did not constitute "an interest of the debtor in property." *Id*. at 196. Accordingly, there was no diminution and hence the Trustee could not avoid the transfers. *See id*. at 196-98.

The bedrock principle that a fraudulent transfer requires diminution of the estate is not limited to situations in which assets are never available to creditors at large, as in *Gredd I*.

If assets that *are* available to satisfy creditors are transferred, even with an intent to defraud creditors, and yet the transfer does not diminish the *res* to which creditors can look for their recovery, that transfer is likewise unavoidable. *See Lippe* v. *Bairnco Corp*., 249 F. Supp. 2d 357, 375-78 (S.D.N.Y. 2003) (summary judgment for defendants granted on actual intent claim for lack of diminution of debtor's assets as a result of transfer); John E. Sullivan, III, *Future Creditors and Fraudulent Transfers*, 22 Del. J. Corp. L. 955, 1041 (1997) ("If, despite his malicious intent, a debtor fails to injure his creditors, then the transfer in question can be left undisturbed.").

A corollary to the principle that a fraudulent transfer requires diminution of the estate is that fraudulent transfer law permits creditors to recover only those assets to which they could have *fairly* looked as a source of recovery on their claims. *See* 2 David G. Epstein, *et al*., *Bankruptcy: Practitioner Treatise Series* § 6-46, at 4-5 (1992) ("The purpose of fraudulent conveyance law, whatever its form, is simple: it protects a debtor's unsecured creditors from *unfair* reductions in the debtor's estate to which they look, generally, for their security." (emphasis added)); 1 Glenn, *Fraudulent Conveyances and Preferences* § 195, at 348 ("*unjust* diminution of the estate" required (emphasis added)). One consequence of this requirement is that a creditor with knowledge of a transfer cannot later seek its avoidance. *See*, *e.g*., *Kupetz* v. *Wolf*, 845 F.2d 842, 850 & n.16 (9th Cir. 1988) (bankruptcy trustee lacked standing to avoid "well-publicized" transfer about which creditors "knew or could easily have found out"); *In re Bergman*, 293 B.R. 580, 586 & n.8 (Bankr. W.D.N.Y. 2003) (fully disclosed transfer not intentionally fraudulent since "'future creditors with notice have no basis to complain'" (citation omitted)).

In sum, the *sine qua non* of a fraudulent transfer is that it diminish the pool of assets to which creditors can fairly lay claim. *See*, *e.g*., *First Alliance*, 471 F.3d at 1008; *Lippe*, 249 F. Supp. at 375-76. That requirement manifests itself throughout the Bankruptcy Code's avoidance provisions. In *Gredd I*, the phrase "an interest of the debtor in property" in section 548(a)(1) was correctly interpreted by this Court to incorporate the diminution requirement. 275 B.R. at 193-99. Here, it is the "initial transferee" requirement of section 550(a) that prevents Bear Stearns from being held liable for Deposits that did not harm the Fund's creditors.

**B. Application of the Unjust Diminution Requirement: The "Dominion and Control" Test**

Section 550(a)(1) of the Bankruptcy Code imposes liability for fraudulent transfers on "initial transferees," a term that is not defined in the Bankruptcy Code. Given the absence of a statutory definition, and the recognition that "'[t]ransferee' . . . must mean something different from 'possessor' or 'holder' or 'agent,'" courts have defined "initial transferee" in a manner rooted in "[t]he functions of fraudulent conveyance law"—*i.e.*, protecting creditors from unjust diminution of the debtor's estate. *See Bonded Fin. Servs., Inc.* v. *European American Bank*, 838 F.2d 890, 892-94 (7th Cir. 1988); *accord In re Red Dot Scenic, Inc.*, 293 B.R. 116, 121 (S.D.N.Y. 2003) (section 550(a) "protects creditors from last-minute depletions of the value of the bankruptcy estate"), *aff'd* 351 F.3d 57, 58 (2d Cir. 2003). As a result, the judicial consensus reflected in the law of this Circuit is that an "initial transferee" is a person that takes away "dominion and control" of fraudulently transferred assets from the debtor.

The Seventh Circuit's seminal decision in *Bonded* has been accepted by the Second Circuit as the touchstone for analysis of "initial transferee" liability. *See In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52, 56-58 (2d Cir. 1997) (following the "widely adopted" logic of *Bonded*); *Red Dot*, 293 B.R. at 119 (adopting the "'dominion and control test' explicated by the Seventh Circuit in *Bonded*"), *aff'd* 351 F.3d at 58. In *Bonded*, the debtor ("Bonded") sent a check to a bank (the "Bank") payable to the Bank's order with instructions to deposit the money into the personal account of one of Bonded's principals ("Ryan"). Although Ryan would eventually use the funds deposited by Bonded to reduce his own debt to the Bank, the Bank initially did nothing more than deposit the funds into Ryan's personal account, pursuant to Bonded's instructions. The question presented was whether the Bank, as opposed to Ryan, was the "initial transferee" of the transfer of Bonded's funds into Ryan's account. *Id*. at 891.

In answering this question in the negative, Judge Easterbrook began by emphasizing the purpose of fraudulent transfer law: "Fraudulent conveyance law protects creditors from last-minute diminutions of the pool of assets in which they have interests. They accordingly need not monitor debtors so closely, and the savings in monitoring costs make businesses more productive." *Id*. at 892. Fraudulent transfer law thus permits the avoidance of transfers that "reduce the value of the debtor's estate and thus the net return to creditors as a group." *Id*.

Initial transferees, the Seventh Circuit explained, are liable for fraudulent transfers because a party that conducts business with the debtor is in a favorable position to determine whether a transfer will result in an unjust diminution of the estate. *Id*. at 892-93. That logic, however, does *not* apply to a financial intermediary, who "receive[s] nothing from [the transferor] that it [can] call its own," and thus derives no economic benefit at the expense of creditors. *Id*. at 893. It would be unreasonable, if not impossible, for such intermediaries to monitor each of their numerous customers' business activities. *Id*. Moreover, were they required to do so, the "staggering" costs that would result would have to be passed on to solvent customers. *Id*. ("Exposing financial intermediaries . . . to the risk of disgorging a 'fraudulent conveyance' . . . would lead them to take precautions, the costs of which would fall on solvent customers without significantly increasing the protection of creditors."). Because financial intermediaries are particularly ill-suited to be charged with monitoring the diminution of a debtor's estate, the *Bonded* court concluded as follows: "[W]e think 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*." *Id*. (emphasis added).

Applying the "dominion and control" test to the facts before it, the *Bonded* court held that the Bank "received no benefit" from Bonded's deposit because the Bank was acting solely as "Ryan's agent for the purpose of collecting a check from Bonded's bank," and thus was a "mere conduit" of the deposit destined for Ryan's account. *Id*. at 893-94. Until the Bank was instructed ten days later to debit Ryan's account to satisfy the Bank's own claim against Ryan, Ryan alone was "free to invest the whole $200,000 in lottery tickets or uranium stocks." *Id*. at 894. Ryan, therefore, as opposed to the Bank, was the party with the economic interest in Bonded's transfer, and hence was the "initial transferee."

In *Bonded*, an agent for the *transferee* was treated as a "mere conduit" for the transfer of funds from the debtor. The "dominion and control" test applies with equal force, however, where it is the *transferor*'s agent that serves as "mere conduit." In *Finley*, for example, the Second Circuit held that, notwithstanding the commercial relationship between a debtor and its insurance broker, the broker had acted as a "mere conduit" for the debtor when it delivered premiums from the debtor to its insurer. *See Finley*, 130 F.3d at 58-59 ("[A] commercial entity that, in the ordinary course of its business, acts as a mere conduit for funds and performs that role consistent with its contractual undertaking in respect of the challenged transaction is not an initial transferee within the meaning of § 550(a)(1)"). Similarly, in *In re Pony Express Delivery Servs*., 440 F.3d 1296, 1301 (11th Cir. 2006), the Eleventh Circuit held that the debtor's insurance broker was not an initial transferee because the broker was "duty-bound to take only limited actions with respect to the funds received."

In concluding that the debtor's broker was not an "initial transferee," the *Pony Express* court agreed with *Bonded* that "a recipient of an avoidable transfer is an initial transferee only if they exercise legal control over the assets received, such that they have the right to use the assets for their own purposes. . . ." *Id*. at 1300 (citing *Bonded*, 838 F.2d at 893). Numerous other courts have reached the same conclusion. *See*, *e.g*., *In re Hurtado*, 342 F.3d 528, 535 (6th Cir. 2003) (recipient was "initial transferee" because she "had legal authority to do what she liked with the funds; she could have invested the funds in 'lottery tickets and uranium stocks'"); *Rupp* v. *Markgraf*, 95 F.3d 936, 941 (10th Cir. 1996) ("[T]he dominion and control test from *Bonded* requires control over the funds and the right to put those funds to *one's own purpose*[.]" (emphasis in original)); *In re Coutee*, 984 F.2d 138, 141 (5th Cir. 1993) (recipient of funds is "initial transferee" only if it has "legal right to put the funds to its own use"); *Red Dot*, 293 B.R. at 123 (parties lacking "the right to invest [transferred] money at will" are not "initial transferees"), *aff'd* 351 F.3d at 58.[3] As explained in *Bonded*, only one who is free to use the debtor's property for its own ends has the requisite economic interest in a fraudulent transfer such that it should bear the risk of avoidance. Lacking such a proprietary interest, mere intermediaries should be burdened with no such avoidance risk. *Bonded*, 838 F.2d at 892-93.

## II. BEAR STEARNS WAS NOT AN INITIAL TRANSFEREE OF THE DEPOSITS.

The fundamental principle that a fraudulent transfer requires unjust diminution, as applied in cases interpreting section 550(a) of the Bankruptcy Code, yields only one conclusion

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[3] *Accord*, *e.g*., *In re Cassandra Group*, 312 B.R. 491, 496 (Bankr. S.D.N.Y. 2004) ("Under the 'dominion and control' 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.'" (Lifland, J.) (quoting *Bonded*; "initial transferee" status denied)); *Securities Investor Prot. Corp.* v. *Stratton Oakmont, Inc*., 234 B.R. 293, 313 (Bankr. S.D.N.Y. 1999) ("an initial transferee is the person who has dominion and control over the subject of the initial transfer to the extent that he or she may dispose of it as he or she pleases, such as 'invest[ing] the whole [amount] in lottery tickets or uranium stocks'" (quoting *Finley*)).

in this case: Fraudulent transfer liability should not have been imposed on Bear Stearns. Since the Fund alone maintained "dominion and control" over the assets in its customer account, the estate was not diminished at all, let alone unfairly diminished, when the Deposits were added to the Fund's account at Bear Stearns. At the same time, Bear Stearns never obtained "dominion and control" over the Deposits: Bear Stearns was not permitted to use the Deposits for its own purposes, and its rights under the Account Agreement pale in comparison with the rights that would be required to establish "initial transferee" status.

## A. The Fund's Retention of "Dominion and Control" Over the Deposits Precludes Recovery from Bear Stearns.

The Trustee seeks to recover Deposits made from one of the Fund's accounts (at Bank of Bermuda) to another of the Fund's accounts (at Bear Stearns). What the Trustee studiously ignores, but which is incapable of dispute, is that the Fund alone remained the beneficial owner of the sums in its Bear Stearns account, and had complete authority over how those sums were invested, subject only to regulatory and contractual margin requirements. After each of the Deposits was made, the Fund's options included (i) liquidating its positions and closing its account, (ii) directing Bear Stearns to use the Deposits as margin for short sales, or (iii) investing all available amounts "in lottery tickets or uranium stocks." *Bonded*, 838 F.2d at 894. Whatever option the Fund chose, it alone had the authority to "use the [Deposits] for [its] own purposes," and therefore had "dominion and control" over those funds. *Pony Express*, 440 F.3d at 1300.

Viewing the Fund itself as the "initial transferee" of the Deposits is the only sensible outcome in these circumstances. The Deposits did not diminish the pool of assets to which the Fund's creditors could fairly look for recovery. On the contrary, the property deposited in the Fund's account was accessible to creditors both before and after the Deposits were made. That circumstance changed only when the funds in the account were depleted as a result of unprofitable securities trading directed by the Fund.

The Deposits, moreover, represented exactly what the Fund's investors knew and intended that the Fund would do with their invested capital. The Fund's Confidential Memorandum expressly stated that "short selling is intended to be an integral component of the Investment Manager's overall strategy," which "involves selling securities that the [Fund] does not own," and that the Fund must therefore "borrow such securities from a third party lender, using margin accounts." R. 99, Ex. 8 (July 1998 Confidential Memorandum) at 7, 9. The Trustee, as the Fund investors' legal representative, cannot now be heard to complain that transfers that the Fund's own investors knew would be made to implement the Fund's legitimate trading activities may be avoided under the auspices of fraudulent transfer law. *See*, *e.g.*, *Kupetz*, 845 F.2d at 850 & n.16 (bankruptcy trustee could not avoid "well-publicized" transfer about which creditors "knew or could easily have found out").

Since the Deposits did not diminish the Fund's estate, let alone unfairly, imposition of liability on Bear Stearns would directly contravene the purpose of the Bankruptcy Code's avoidance provisions, namely "protect[ing] creditors from last-minute diminutions of the pool of assets in which they have interests." *Bonded*, 838 F.2d at 892. The "dominion and control" test—as applied to this case, in which the Fund indisputably maintained "dominion and control" over the Deposits—precludes the Bankruptcy Court's erroneous conclusion that Bear Stearns was an "initial transferee" of the Deposits.

### B. Bear Stearns Lacked "Dominion and Control" Over the Deposits.

The flipside of the Fund's indisputable dominion and control over the Deposits is the highly limited ability of Bear Stearns to access the Deposits in its capacity as agent and intermediary for the Fund. The Bankruptcy Court's conclusion to the contrary rested on two premises: (1) that the legal restrictions on Bear Stearns' use of the assets in the Fund's account did not preclude it from exercising "dominion and control" over the Deposits (*Gredd II*, 2007 WL 60843, at *8); and (2) that Bear Stearns' rights under the Account Agreement endowed Bear Stearns with such "dominion and control" (*id*. at *9). Neither premise survives scrutiny. As a matter of law, Bear Stearns' inability to employ the Deposits for its own proprietary purposes precludes the conclusion that it was an initial transferee. Moreover, Bear Stearns' contract rights under the Account Agreement did not endow it with "dominion and control" because those rights were both (a) limited to protecting Bear Stearns' status as an agent and intermediary, and (b) contingent upon unforeseen events—particularly market movements contrary to the Fund's chosen investment strategy—that were beyond Bear Stearns' control.

### 1. The Restrictions on Bear Stearns' Access to the Fund's Account Precluded Bear Stearns from Exercising "Dominion and Control" Over the Deposits.

Under the Customer Protection Rule, promulgated under Section 15(c)(3) of the Securities Exchange Act of 1934, a broker-dealer is prohibited from using customer deposits qualifying as "Total Credits" for its own proprietary activities. *See* 17 C.F.R. § 240.15c3-3(e)(2); *Upton* v. *SEC*, 75 F.3d 92, 93 (2d Cir. 1996) ("The Rule is designed to prevent broker-dealers from using funds or securities held on behalf of customers to finance proprietary and other non-customer transactions. . . ."). As it is undisputed that the Deposits were Total Credits as defined in the Rule (*see* R. 113, at 9-11), Bear Stearns plainly lacked "the right to use the [Deposits] for [its] own purposes." *Pony Express*, 440 F.3d at 1300; *Bonded*, 838 F.2d at 893. On the contrary, Bear Stearns was *prohibited* by federal law from using the Deposits as it would use its own money. Moreover, because it received the Deposits as the Fund's intermediary agent, Bear Stearns also had no contractual right or authority to use the Deposits as it wished.

Relying exclusively on the out-of-circuit decision in *In re Incomnet, Inc.*, 463 F.3d 1064 (9th Cir. 2006), the Bankruptcy Court concluded that Bear Stearns could exercise "dominion and control" over the Deposits without being able to use the deposited funds for its own purposes. *Gredd II*, 2007 WL 60843, at *8-9. Even if correctly decided, however, *Incomnet* does not support the Bankruptcy Court's conclusion. What *Incomnet* holds is that a legal constraint on the use of transferred property does not preclude "dominion and control" over that property, *unless* the constraint results from the recipient's status as an agent. Since the constraints on Bear Stearns' use of the Deposits resulted entirely from its agency status, *Incomnet* itself requires reversal of the Bankruptcy Court's decision.

*Incomnet* involved contributions by a telecommunications carrier to the Universal Service Administrative Company ("USAC"), which collected contributions from carriers, pooled them, and then disbursed funds to carriers so they could deliver service to designated beneficiaries. 463 F.3d at 1066-67. When the carrier's creditors sought to recover the carrier's contributions from USAC as preferences, USAC argued that it was a "mere conduit" of the contributions, and not their "initial transferee." The Ninth Circuit rejected this argument on the grounds that USAC alone took legal title to the contributions and had discretion to determine both (i) which carriers would receive the contributed funds, and (ii) which beneficiaries would receive subsidized services. *Id*. at 1072-73, 1075. USAC, therefore, was "neither an agent nor a mere conduit for some other party," but instead functioned as "a distinct legal entity" that held "legal title" to the contributions for its own account. *Id*. at 1073, 1075. The court further rejected USAC's argument that the statutory limitations on USAC's deployment of the contributions—for example, USAC had to "disburse funds to subsidize the provision of service to libraries, schools, rural areas, and high cost areas," *id*. at 1072—precluded it from exercising dominion over them:

> Here, USAC received the funds from Incomnet without any restrictions *from Incomnet* on their use. USAC commanded those funds and, like other individuals, its use of those funds was restricted by law. These legal restrictions merely limit

> how USAC will exercise its dominion over the funds; they do not preclude USAC from having dominion at all.

*Id*. at 1075 (emphasis in original; citation omitted). In other words, the statutory limitations on USAC's use of carrier contributions did not affect USAC's dominion over the contributions because those constraints were not imposed by the carrier pursuant to an agency relationship.

Although *Incomnet* itself repeatedly describes "dominion" over assets as "the ability to use them as [one] sees fit," 463 F.3d at 1071, 1073, the decision shows that "initial transferee" status in fact turns also on the *capacity* in which the recipient receives the debtor's assets. If a party receives a payment from the debtor for its own account, but is restricted in its use of the payment for reasons unrelated to a principal-agent relationship, then that party nonetheless may have dominion over the payment. *Id*. at 1075-76. On the other hand, if a party receives a payment in its capacity as an agent—either for the debtor or for the ultimate recipient of the transfer—the restrictions imposed by the agency relationship preclude the exercise of dominion over the payment. In *Incomnet*, USAC had dominion over the carriers' contributions because it was not acting on instructions from either the contributing carriers or from the parties to whom it disbursed funds. *See Incomnet*, 463 F.3d at 1074-75 ("USAC is neither the agent of, nor a trustee for, carrier recipients," and "USAC has not established that there is any binding legal relationship between it and any of [its] beneficiaries").

This focus on the constraints imposed by principal-agent relationships is entirely consistent with other decisions applying the "dominion and control" test. In *Pony Express*, the Eleventh Circuit explained that the "dominion and control" test "takes on special significance where the recipients of avoidable transfers are agents or fiduciaries of the debtor-transferor, such as banks or, in this case, insurance brokers, who are duty-bound to take only limited actions with respect to the funds received." 440 F.3d at 1300-01. Courts in this Circuit have likewise recognized that an agent whose discretion is limited by its principal is the antithesis of an "initial transferee." *See Finley*, 130 F.3d at 59 (insurance agent transmitting premiums on behalf of debtor not "initial transferee").[4]

Like any securities broker acting for its customer, Bear Stearns was a financial intermediary with essentially no discretion over the Fund's use of its Deposits. The Deposits were made with Bear Stearns solely to carry out the Funds' trading activities. Federal law prevented Bear Stearns from using the Deposits for its own proprietary purposes; the Fund determined its own investment strategy; and, to the extent the Fund had sufficient margin, it could withdraw funds from its account as it desired. In light of these realities, there can be no question that Bear Stearns was acting as a financial intermediary, *i.e.*, as an agent for the Fund, in respect of the Deposits. *See*, *e.g*., *In re Dominion Corp*., 199 B.R. 410, 415 (9th Cir. BAP 1996) (Charles Schwab acted as "intermediary" rather than "transferee" with respect to funds held in customer brokerage accounts) (summary judgment for stockbroker affirmed); *In re Kaiser Steel Corp*., 110 B.R. 514, 521 (D. Colo. 1990) (Charles Schwab acted as "financial intermediary" rather than "transferee" with respect to funds paid to Schwab for customers' accounts), *aff'd on other grounds*, 913 F.2d 846 (10th Cir. 1990); *cf.* N.Y.U.C.C. § 8-102(a)(14) ("'Securities Intermediary' means . . . a person, including a bank or broker, that in the ordinary course of business maintains securities accounts for others and is acting in that capacity."). Since the substantial legal, regulatory, and contractual restrictions on Bear Stearns' use of the Deposits followed completely from its function as a financial intermediary, Bear Stearns cannot properly

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[4] *Accord Cassandra Group*, 312 B.R. at 496-97 (attorney who received payments from debtor on behalf of client not "initial transferee"); *In re Black & Geddes*, 59 B.R. 873, 875 (Bankr. S.D.N.Y. 1986) (steamship agency acting as commissioned collection agent not "initial transferee"); *In re Fabric Buys of Jericho, Inc*., 33 B.R. 334, 337 (Bankr. S.D.N.Y. 1983) (law firm acting as escrow agent not "initial transferee").

be deemed an "initial transferee." On that basis alone, the Bankruptcy Court's decision should be reversed.

### 2. Bear Stearns Did Not Have "Dominion and Control" Over the Deposits by Virtue of Its Limited Rights Under the Account Agreement.

Having erroneously concluded that the imposition of "initial transferee" liability on Bear Stearns did not clash with the restrictions on Bear Stearns' use of the Deposits, the Bankruptcy Court compounded that error by concluding that Bear Stearns had "dominion and control" over the Deposits because of its limited rights under the Account Agreement. *Gredd II*, 2007 WL 60843, at *9. In so concluding, the Bankruptcy Court overlooked two distinguishing features of Bear Stearns' contract rights: (i) they merely protected Bear Stearns from having to step out of its agency capacity; and (ii) their exercise was entirely contingent upon unforeseen events beyond Bear Stearns' control—the success or failure of the Fund's chosen investment strategies in the securities markets.

*First*, under the Account Agreement, Bear Stearns could do no more than use *the Fund's* money to meet *the Fund's* outstanding obligations, including to buy "covering securities" and return them to Bear Stearns. Like the margin regulations, the Account Agreement merely protected Bear Stearns from having to access its own capital in order to "stand behind" its customer's trading activities; it did not allow Bear Stearns to obtain property that "it could call its own" from the Fund. *Bonded*, 838 F.2d at 893. As recognized by this Court in *Gredd I*, a broker's ability to act as intermediary without being forced to risk its own capital is essential to the efficient operation of the securities markets. *See Gredd I*, 275 B.R. at 198.

The courts have repeatedly held that an intermediary does not obtain "dominion and control" over its principal's funds merely because it can use those funds to protect itself in its capacity as an intermediary. In *Finley*, for example, an insurance broker's power to deduct a commission from a debtor's payment to its insurer did not make the broker an "initial transferee" of the payment. 130 F.3d at 59; *accord Coutee*, 984 F.2d at 141 (law firm's contractual right to deduct legal fees from trust account did not confer "dominion and control" over account). Indeed, notwithstanding the rights held by securities brokers, courts have specifically refused to treat them as "initial transferees" in disregard of their intermediary agent status. *See Dominion Corp.*, 199 B.R. at 413-14 (Charles Schwab's lien on funds and securities in customer account, which Schwab used to reimburse itself after an overdraft, did not confer "dominion and control" over the customer account funds); *Kaiser Steel*, 110 B.R. at 521 (Charles Schwab's "lien and repossession rights" on funds and securities in customer account did not confer "dominion and control"). As the *Kaiser Steel* court observed in rejecting the very logic adopted by the Bankruptcy Court here:

> Kaiser seeks to establish that Schwab exercised dominion over the funds paid to its customers by referencing certain provisions in Schwab's customer agreements which grant it a lien on assets held by Schwab. . . . As noted by the SEC, however, Commission regulations set strict requirements on a broker's use of customer funds to protect against misuse and abuse. *See* 17 C.F.R. 240.15c3-3. Schwab's customer agreements provide that the broker's lien and repossession rights are only to secure amounts due Schwab. There is no evidence that Schwab could arbitrarily apply customer funds for its own benefit.

*Id.* Here, Bear Stearns was no different from Charles Schwab, whose alleged "initial transferee" status was correctly rejected in both *Dominion Corp.* and *Kaiser Steel*.[5]

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[5] Decisions protecting securities intermediaries from suits by representatives of bankrupt estates have a sound basis not only in bankruptcy law, but also in state law governing liability of securities intermediaries for the acts of their principals. Under the Uniform Commercial Code, a securities intermediary is liable to an adverse claimant to a customer's assets only if it "acted in collusion with the wrongdoer in violating the rights of the adverse claimant." *E.g.*, N.Y.U.C.C. § 8-115(2). The District Court has already ruled that Bear Stearns did *not* participate in Berger's alleged fraud on investors. *See Cromer Finance*, 137 F. Supp. 2d at 469-72.

*Second*, the exercise of Bear Stearns' rights under the Account Agreement was contingent on the Fund's margin position becoming inadequate. *If* that occurred, then Bear Stearns could effect additional transfers on the Fund's behalf, using the Fund's money to buy securities needed to cover the Fund's short positions, in order to keep Bear Stearns in a "neutral" economic position. Imposing "initial transferee" liability on Bear Stearns would have the anomalous effect of permitting the Trustee to avoid transfers (the Deposits) merely because their custodian was entitled, in certain unforeseen circumstances, to use the transferred funds to effect *subsequent* transfers necessitated by the Fund's own unsuccessful investments. It is only the subsequent transfers, however, that could have affected the Fund's creditors by reducing both the amount of cash in the Fund's account (through the purchase of covering securities) and the Fund's overall short position (through the return of covering securities to Bear Stearns). Those subsequent transfers, however, are not subject to avoidance as a matter of law.[6]

Like the Bank in *Bonded*, therefore, Bear Stearns "received no benefit from [the Deposits]" challenged by the Trustee, even though, as in *Bonded*, those transfers could eventually lead to subsequent (and here unavoidable) transfers that would relieve Bear Stearns of potential liability arising out of the Fund's unsuccessful trading activities. For precisely the same reasons that the Seventh Circuit declined to impose initial transferee liability on the Bank in *Bonded*, this Court should decline to impose "initial transferee" liability on Bear Stearns.

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6 It is law of this case that transfers of securities purchased by required margin are unavoidable, because neither the margin amounts used to purchase the securities nor the transferred securities themselves constitute "an interest in the debtor in property." *Gredd I*, 275 B.R. at 196-99. Moreover, a transfer made to pay a debt owing to Bear Stearns would not be avoidable because payments on account of antecedent debt do not diminish the estate. *See*, *e.g.*, *In re All-Type Printing, Inc.*, 274 B.R. 316, 324 (Bankr. D. Conn. 2002), *aff'd*, 80 Fed. Appx. 700 (2d Cir. 2003).

## CONCLUSION

Imposition of "initial transferee" liability on Bear Stearns would expand fraudulent transfer law far beyond its acknowledged limits, set novel precedent endangering the efficient functioning of the financial markets, and provide a windfall to the Fund's investors. The judgment of the Bankruptcy Court should be reversed.

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Respectfully submitted,

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