NAVIGATING THE SAFE HARBORS: TWO BRIGHT LINE RULES TO ASSIST COURTS IN APPLYING THE STOCKBROKER DEFENSE AND THE GOOD FAITH DEFENSE*

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I. INTRODUCTION

In the spring of 1996, Michael Berger formed an offshore investment company known as Manhattan Investment Fund, Ltd. ("the Fund").[1] Berger, serving as the only active director for the Fund, employed a risky strategy of short-selling – an investment tactic that essentially bet on particular stocks dropping in value over a certain period of time.[2] Berger's hunch was that various technology and Internet-related stocks were overvalued and thus, ripe for "shorting."[3] This hunch, while accurate at its inception, proved to be a disastrous miscalculation that eventually brought the Fund to financial ruin, leading to losses of nearly $300 million over the next four years and a chain of cover-ups and misdeeds that would leave Berger pleading guilty to several criminal counts of securities fraud in the summer of 2000.[4]

Two of the chief questions left for courts in the wake of a collapse like Manhattan Investment Fund is how to equitably handle the rights of all the players involved, and perhaps more importantly, how to best divvy the remaining assets in accordance with those rights.[5] Concerns like these

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[1] S.E.C. v. Berger, 322 F.3d 187, 188-90 (S.D.N.Y. 2003).

[2] Bear, Stearns Sec. Corp. v. Gredd, 275 B.R. 190, 192, n.3 (S.D.N.Y. 2002) ("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.").

[3] Berger, 322 F.3d at 188-90.

[4] *See id.*; *see also* Julie Creswell, *Bear Stearns Told to Pay $160 Million to Investors*, N.Y. TIMES, Feb. 16, 2007, at C1 ("The [F]und lost nearly $300 million of investors' money by making wrong bets on Internet stocks during the technology boom of the late 1990s.").

[5] Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: an Overview and Insolvency Perspective*, 29 CAL. BANKR. J. 213, 242-44 (2007) (discussing various ways hedge funds approach insolvency, such as restructuring and liquidation, as well as the

carry special significance during a particularly volatile time in the market when stories about the nation's credit crunch and mortgage woes continue to dominate headlines across the country.[6] Indeed, as more and more hedge funds and other alternative investment companies are forced to declare insolvency, courts are increasingly being asked to answer this problematic question.[7] Accordingly, the chief focus for the affected parties becomes not just how courts will interpret their rights but further, whether they can reliably depend on those rights to protect them during the bankruptcy process.[8]

For purposes of illustration, this Note will focus on the rights and obligations of only one of the many parties implicated when a hedge fund dissolves – the prime broker.[9] Part II begins with a background discussion of safe harbors generally and focuses on some of the main policy arguments that first prompted Congress to take action. It explains the intended effect of these safe harbors during the bankruptcy process for financial players like prime brokers and how

different rights that each type of creditor—secured and unsecured—has in each situation).

[6] Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1 (discussing the global impact and potential worldwide failure of hedge funds from the U.S. subprime mortgage crisis); Craig Ip, *How Credit Got So Easy and Why It's Tightening*, WALL ST. J., Aug. 7, 2007, at A1; Vikas Bajaj, *Foreclosures Surged 36% in August, Report Says*, N.Y. TIMES, Sept. 18, 2007 at C3; *Mortgage Mayhem*, FORTUNE, Sept. 3, 2007.

[7] *See* Futter & Wells, *supra* note 5, at 241-46 (discussing the potential trickle down effects from the massive industry failure of subprime mortgages and subsequently, funds that invested in securitized loan portfolios).

[8] *Id.* at 245 (positing that the new trend for insolvent hedge funds will be workouts or other out of court agreements to avoid the courtroom, "[g]iven the unpredictability of chapter 11, inconsistent application of laws by judges, and the tremendous expense of chapter proceedings").

[9] *See infra* Part II.B (discussing the specific functions of the prime broker, the critical role that prime brokers play in the securities industry, and how Congress, in recognizing this, has acted with the Securities and Exchange Commission to encourage their robust involvement in the marketplace).

these special protections operate ultimately to further Congress's goals of providing stability, consistency, and clarity in the marketplace.[10] Part II concludes with a brief but important examination of fraud and the impact that its increased role in the financial marketplace has had on courts. Crucial to this portion of the discussion is the notion that courts, by restricting or enlarging the definition of fraud, can still retain a very active role as a gatekeeper to these safe harbors.

Part III narrows this discussion, focusing on two prominent safe harbors in the Bankruptcy Code ("Code") for financial parties: the stockbroker defense[11] and the good faith defense.[12] Part III discusses each provision in detail, analyzing the protections each defense offers to parties during the bankruptcy process. Part III also explains and analyzes the Congressional policies that are furthered by granting such protections to these financial parties and how courts, in using fraud and other devices to play too large of a gatekeeping role, can ultimately undermine these policies by adding instability and uncertainty to the marketplace.

Part IV offers a resolution to this problem, recommending two bright line rules courts should use when determining whether to grant parties a safe harbor under the stockbroker defense and the good faith defense. These rules act both to prevent further erosion of these protections and to promote the policies clearly stated by Congress when it enacted these provisions. Part IV concludes by explaining how the application of these rules will provide courts with a

[10] Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 91 (2005) ("The Code contains numerous provisions affording special treatment to financial derivatives contracts . . . . No other counterparty or creditor of the debtor has such freedom; to the contrary, the automatic stay prohibits them from undertaking any act that threatens the debtor's assets.").

[11] 11 U.S.C. § 546(e) (2005); *see infra* notes 35-39, 93-95 and accompanying text.

[12] 11 U.S.C. § 548(c) (2005); *see infra* notes 40-42, 99-107 and accompanying text.

pragmatic approach that will deliver consistent and reliable results.

II. SAFE HARBOR PROVISIONS AND THE IMPLICATIONS OF FRAUD

Counterparties to financial contracts have enjoyed special rights and privileges under the Bankruptcy Code since 1978.[13] Nearly all other creditors during a bankruptcy proceeding are subject to provisions that constrain their rights, such as the automatic stay,[14] the avoidance of preferential[15] and fraudulent transfers,[16] and the nullification of *ipso facto*[17] and discrimination clauses.[18] Qualified financial counterparties, however, remain largely unaffected; they are free to assert the same rights inside bankruptcy as they would be able to outside.[19] The protections these safe harbors provide become even more pronounced when looking at amendments to the Code in Title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Reform Act" or "2005 amendments").[20] Indeed, while only certain counterparties

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[13] Edward R. Morrison & Jeorg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 642 (2005); *see also* Bruce H. White & Bryan L. Elwood, *Are You Sailing in Safe Harbors?*, AM. BANKR. INST. L. REV. 44 (Jan. 26, 2008) (giving examples of safe harbors in the Bankruptcy Code provided for forward contracts and swap agreements).

[14] 11 U.S.C. § 362(a) (2005) (defining automatic stay).

[15] *Id.* § 547(b) (defining preferential transfer).

[16] *Id.* §§ 544(b), 548 (defining fraudulent transfer under non-bankruptcy and bankruptcy law).

[17] *Id.* §§ 365(e), 541(c) (providing different anti *ipso facto* clauses).

[18] *Id.* § 525(a) (nullifying discrimination clauses on account of debtor's bankrupt status).

[19] *See* Morrison & Riegel, *supra* note 13, at 645 ("The Code calls off the automatic stay, prohibition on ipso facto clauses, and its preference and constructive fraudulent conveyance rules.").

[20] For further reading on the 2005 amendments, see Morrison & Riegel, *supra* note 13, at 642 (citing BAPCA §§ 401-47 that are now codified in various sections throughout Title 11 of the United States Code).

qualified for such protections in the original installments of the Bankruptcy Code,[21] the Reform Act signals a Congressional intent to extend these protections to a dramatically larger portion of the financial world.[22] Moreover, the new changes also indicate Congress's desire to remove courts from the decision-making process altogether by leaving the interpretation of key financial terms to industry customs rather than the courts.[23]

This Note argues that despite these strong indications from Congress, courts have not consistently followed Congressional intent and as a result, courts have added unnecessary instability and uncertainty to the marketplace. While the Reform Act may have appeared to implement sweeping reforms and protections for financial counterparties, courts have nevertheless retained a major role in determining how much protection these safe harbors ultimately provide.[24]

A. The Policy Behind Safe Harbor Provisions

Congress's main motivation in creating safe harbors in the Bankruptcy Code was to promote stability within the

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[21] *Id.* ("Parties to some contracts (such as forwards) enjoyed these rights as early as the original 1978 Code. Parties to other contracts had to wait for amendments in the early 1980s, in 1990, or, most recently, in Title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.").

[22] *Id.* at 641 (commenting on the larger effect of the expanded definitions under the 2005 reforms that may lead to market-wide protections for financial participants. "The expanded definitions . . . are now so broad that nearly *every* derivative contract is subject to the Code's protection. Instead of protecting particular counterparties to particular transactions, the Code now protects any counterparty to any derivatives contract. Entire markets have been insulated . . . . ").

[23] *See infra* notes 33-34 and accompanying text; *see also* Morrison & Riegel, *supra* note 13, at 644 ("[T]he new role of judges is to apply industry custom to financial contracts in much the same way that they would apply custom to interpret a contract under the Uniform Commercial Code.").

[24] *See infra* Parts III.A.1 and III.B.1.

financial sector.[25] This is especially apparent in looking at the Code's protection of important but volatile financial instruments like derivatives,[26] securities,[27] and commodity contracts.[28] Safe harbors attempt to create this stability by protecting the expectations of counterparties when entering into such transactions or contracts.[29] By not having to worry about provisions like the automatic stay (which would serve to incapacitate the counterparty during bankruptcy) and preferential or constructively fraudulent transfers (which would prevent counterparties from receiving the benefits of their bargain under the financial contract), financial firms can enter into relationships confident that their status and rights will remain largely intact.[30] Ultimately, this protects

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[25] *See* H.R. Rep. No. 109-31 at 3, 20, 131, 132 (2005) (justifying amendments to the Code as "provisions designed to reduce systemic risk in the marketplace").

[26] *See* Edwards & Morrison, *supra* note 10, at 93 ("A *derivative* is a financial instrument whose price depends on the value of the underlying asset, such as common stock. A *derivatives contract* defines the rights and obligations of the buyer and seller of the derivative ('the counterparties'). Examples include forward contracts (obligating one party to buy the underlying asset from another party at a certain price at a future date), options (giving one party the right but not the obligation to buy the underlying asset at a certain price at a future date) and swaps (obligating the two parties to exchange cash flows from underlying assets for a set period).").

[27] 11 U.S.C. § 741(7) (2005) ("'Securities contract' means a contract for the purchase, sale, or loan of a security . . . including an option to purchase or sell any such security, certificate of deposit, or group or index" of securities.).

[28] *See* Edwards & Morrison, *supra* note 10, at 93 & n.7 ("A 'commodity contract' includes, inter alia, 'with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade.'") (citing 11 U.S.C. § 741(7) (2005)).

[29] *See* White & Elwood, *supra* note 13, at 44 (citing H.R. REP. 101-84 (1990)), *reprinted in* 1990 U.S.C.C.A.N. 233 ("[L]egislative history states that the primary purpose of these protections 'is to ensure that the . . . financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code.").

[30] *See* Morrison & Riegel, *supra* note 13, at 642 (explaining that Congress did not want to subject counterparties to financial contracts to

the market from systemic risk by preventing the downward spiral of one financial firm from affecting others around it and creating a domino-like effect of insolvency from one market player to another.[31] Moreover, it allows for cheaper and more efficient transactions because it prevents parties from having to engage in costly or time-consuming risk analyses, since the uncertainty of bankruptcy is out of the picture.[32]

Significantly, Congress has taken a further step to ensure availability of these protections. Under the 2005 amendments, Congress directs courts to use industry custom in determining whether "financial contracts" and "financial

the automatic stay because "[t]hey would be unable to liquidate volatile contracts and thereby limit their exposure to market movements").

[31] Harold S. Novikoff & Igor Fuks, *Special Bankruptcy Code Protections for Derivative and Other Financial Market Transactions,* Wachtell, Lipton, Rosen, & Katz Memorandum, at 3 (Sept. 5, 2007) (on file with author) ("The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature of the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.") (citing H.R. REP. NO. 420, 97th Congr., 2d Sess. 1 (1982)); David B. Young, *Preferences and Fraudulent Transfers*, 895 PLI/COMM 713, 915 (2007) ("Congress was concerned that such avoidance would upset the system of guarantees and commitments on each side of a commodities or securities trade, and Congress wished to prevent the insolvency of one firm from destabilizing the entire industry.") (citing H.R. REP. No. 420, 97th Cong., 2d Sess., 1 (1982)).

[32] *See* Novikoff & Fuks, *supra* note 31, at 3-4 ("It is essential that stockbrokers and securities clearing agencies be protected from the issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent's position, because market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the other who carry accounts for that party and undermine the integrity of those markets.") (citing 128 Cong. Rec. 58, 133 (July 13, 1982) (statement by Sen. Dole)); *see also* Young, *supra* note 31, at 915 (explaining importance of reducing risk in the financial industry); Joseph J. Bassano et al., *Value Requirement – Margin and Settlement Payments; Master-netting Agreements*, 9C AM. JUR. 2D BANKRUPTCY § 2306 (2007).

participants" receive special standing under the Code.[33] By doing this, Congress not only precludes courts from taking any action that would undermine Congress's overall goals of providing stability and predictability to the marketplace and its actors, but Congress also prevents courts from having to engage in difficult line-drawing determinations that could lead to inconsistent and unreliable holdings.[34]

This Note focuses on two safe harbors that carry special significance in the hedge fund and investment industry. The first is the stockbroker defense and is typically asserted by a creditor who is trying to prevent payments that were made by the debtor from being pulled back into the debtor's estate as a preferential or fraudulent transfer.[35] This provision is aptly named the stockbroker defense because it is invoked by brokers and other financial professionals to prevent the avoidance of settlement[36] or margin payments[37] made by the

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[33] *See* Morrison & Riegel, *supra* note 13, at 644 ("By relying on broad market definitions, the Act gets judges out of the (largely futile) business of second-guessing financial contracts.").

[34] *See id.* ("Indeed, if anything is clear from the new Code, it is that judges are strongly discouraged from engaging in functional analysis of contracts.").

[35] 11 U.S.C. § 546(e) (2005) ("Notwithstanding sections 544, 545, 547 [preferential transfer], 548(a)(1)(B) [constructively fraudulent transfer], and 548b of this title, *the trustee may not avoid a transfer that is a margin payment . . . or settlement payment* . . . made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, *except under section 548(a)(1)(A) of this title.*") (emphasis added).

[36] A settlement payment has been broadly construed to encompass payments made to complete transactions involving securities and its corresponding funds. Kaiser Steel Res., Inc. v. Jacobs (*In re* Kaiser Steel Corp.), 110 B.R. 514, 522, & n.8 (D. Colo. 1990).

[37] When a hedge fund uses a short-selling strategy (discussed *supra* note 2), the prime broker often facilitates the fund's investment strategy by borrowing stocks from third parties, selling them on behalf of the fund, and then placing the proceeds from those sales in a "short account" that credits the proceeds to the hedge fund. Because the prime broker originally borrows the stocks and not the fund, the broker has the ultimate obligation to return the stocks while the fund has open short positions. To mitigate the broker's risk that the fund will become insolvent and unable

debtor in connection with securities or commodities market transactions.[38] Its codification is a direct result of Congressional concern that allowing such avoidances would "upset the system of guarantees and commitments on each side of a commodities or securities trade" and would lead to the destabilization of the entire industry.[39]

The second safe harbor is the good faith defense. As its name indicates, this provision is meant to protect parties that have innocently engaged in transactions with the debtor and are seeking to retain or recover the value of the obligation or service they exchanged with the debtor in the disputed transaction.[40] The good faith defense is available to any party who can establish two essential elements: the transfer resulted in the debtor receiving something from the counterparty "for value"[41] and the counterparty asserting the defense is able to demonstrate that it took the transfer in "good faith."[42]

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to pay its open positions, the broker will require the fund to maintain a margin account with the broker to ensure that there is some capital to pay off these obligations. The payments to the margin account are called margin payments. Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452, 469 (S.D.N.Y. 2001).

[38] *See* Bassano et al., *supra* note 32, § 2306 ("If the recipient of a margin or settlement payment made by a debtor could be forced to return property no longer possessed, the financial stability of the recipient as well as that of other members in the customer-broker-clearing-house chain could be jeopardized.").

[39] *See In re* Kaiser Steel Corp., 110 B.R. at 522 (explaining that a broad definition of a settlement payment "is consistent with the legislative intent behind § 546(e) to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions").

[40] *See* 11 U.S.C. § 548(c) (2005) ("A transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.").

[41] *See infra* note 103 and accompanying text.

[42] *See infra* notes 104-07 and accompanying text; *see also infra* Part III.B (discussing elements of good faith).

B. The Significance of Financial Participants Like Prime Brokers

Prime brokers serve a critical role in the financial industry and are usually hired by hedge funds and other financial firms to provide the processing and administrative services typically required when executing securities transactions for a fund's customers.[43] While the exact allocation of functions between the executing broker (also called the introducing broker[44]) and its prime broker (often referred to as the clearing broker[45]) varies from contract to contract, customer-related functions are universally performed by the introducing firm while bookkeeping, settlement, and clearing responsibilities are always performed by the clearing firm.[46] Because the actions taken

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[43] *See* Henry F. Minnerop, *Clearing Arrangements*, 58 BUS. LAW. 917 (2003) [hereinafter Minnerop, *Clearing Arrangements*] (explaining that Congress gave the SEC a mandate to provide favorable regulatory guidelines to encourage clearing arrangements between investors, broker-dealers, and clearing firms. "Much of the initial impetus for this treatment came in response to the 'paper crunch' of the late 1960s, a crisis that nearly paralyzed Wall Street and led to the collapse of numerous New York Stock Exchange ("NYSE") member firms. These firms were unable to process a rising volume of trades, causing a domino effect of failed settlements of securities transactions among brokerage firms."); *see also* Thomas L. Hazen & Jerry W. Markham, *Broker-Dealer Operations Under Securities and Commodities Law, Chapter 13: Clearing and Settlement*, 23A BROKER-DEALER OPERATIONS SEC. & COMM. LAW § 13:15 (2007) ("Prime brokerage is a system developed by full-service firms to facilitate the clearance and settlement of securities trades for substantial retail and institutional investors who are active participants.").

[44] *See* Minnerop, *Clearing Arrangements*, *supra* note 43, at 920 (giving examples of traditional executing broker activities and customer-contact functions like soliciting customer accounts, determining the customer's investment objectives, recommending transactions in accordance with stated objectives).

[45] *See* Gerald T. Lins et al., *Hedge Funds and Other Private Funds: Reg. and Comp.* § 2:3 (2007) (giving examples of prime broker duties: custody, settlement, execution of portfolio transactions, reporting, financing, etc.).

[46] *See* Minnerop, *Clearing Arrangements*, *supra* note 43, at 919.

by the introducing firm require direct, continuous contact with customers, they are popularly referred to as "front office" functions.[47] Conversely, because many of the functions outsourced to prime brokers rarely bring them into any contact with customers, they are referred to as "back office" functions.[48]

Over the past several decades, these divisions of labor have proven to be essential to the efficient operation of the securities and commodities markets.[49] By allowing introducing firms to contract out clearance and settlement responsibilities to clearing firms, introducing firms are able to avoid the typically large fixed overhead expenses associated with maintaining back office technology and infrastructure.[50] Notably, these front office and back office distinctions also carry particular importance when establishing the legal responsibilities of the two types of brokers. Because the introducing firm handles nearly all of the customer-contact functions, it often bears the full regulatory and supervisory responsibilities with respect to the sales practices of its brokers.[51] Conversely, because of

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[47] *See id.*

[48] *See id.*

[49] *See id.* at 917 ("Acting under the mandate of Congress to address the [crisis from the collapse of numerous New York Stock Exchange member firms], the SEC encouraged the securities industry to develop a modern clearance and settlement system. This the industry did with great success.").

[50] *See id.* at 919; *see also* Lins et al., *supra* note 45, § 2:3 ("Prime brokerage arrangements are common in the hedge fund and alternative investment industry . . . . A prime brokerage arrangement allows these fund managers to rely on prime brokers to provide custody, back office support and other services, while the manager concentrates on managing the fund's portfolio.").

[51] Essentially, the clearing agreement determines whether the introducing firm or the clearing firm has to perform a specific function. Attached to the performance of that function is the supervisory responsibility of ensuring that the transaction being requested is legitimate (i.e., no fraudulent purpose or activity). Because introducing brokers typically have all customer contact—related duties, it is the introducing broker's responsibility, not the clearing broker's, to ensure the customer is not engaging in illegitimate activity. *See* Minnerop, *Clearing*

the distance with which a clearing firm usually operates from the front office, it normally carries no such responsibility and more importantly, no reciprocal obligation to monitor or supervise the sales practices of any of its introducing firms.[52] This lack of an affirmative duty to investigate on the part of clearing agencies, like prime brokers, is mirrored in other areas of the law such as the Uniform Commercial Code[53] and in judicial opinions.[54]

Because prime brokers play a significant role in the investment industry, their rights are likely to be implicated when a hedge fund's fortunes run dry. In these situations, a prime broker will usually turn to an applicable safe harbor provision to ensure that it will be able to enjoy the same rights it did before the bankruptcy filing. Indeed, by amending the Code to allow safe harbors to apply to a much larger community of financial actors, Congress appears to have intended this result.[55] Surprisingly, this ends up not always being the case.

Arrangements, *supra* note 43, at 920 & n.9 (noting that NYSE Rule 382 and NASD Conduct Rule 3230 set out key functions that clearing agreements must allocate between introducing and clearing firms and that these functions also dictate the supervisory roles that each party consequently plays).

[52] *See id.*

[53] Brief for Appellant at 3 & n.2, *In re* Manhattan Investment Fund, 359 B.R. 510 (S.D.N.Y. 2007) (No. 07-02511) [hereinafter SIFMA brief] (on file with author) citing U.C.C. § 8-503 cmt. 3 on the lack of an affirmative duty to investigate in the securities industry. ("Rather than imposing duties to investigate, the general policy of the commercial law of the securities holding and transfer system has been to eliminate legal rules that might induce participants to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer.").

[54] Lesavoy v. Lane, 304 F. Supp. 2d 520, 525-26 (S.D.N.Y. 2004) (clearing firms owed no duty to account-holders' beneficiaries because a broker has "no duty to monitor a nondiscretionary account."); Bonded Fin. Serv., Inc. v. European American Bank, 838 F.2d 890, 898 (7th Cir. 1988) ("A transferee that lacks the information necessary to support an inference of knowledge need not start investigating on his own.").

[55] *See* Morrison & Riegel, *supra* note 13, at 642.

C. Implications of Fraud on the Safe Harbors

Despite the protections these safe harbors are meant to provide for financial parties, courts can still find creative ways to play a determinative role in the bankruptcy process. One way that courts have accomplished this is by finding that more activities, either of the debtor or the creditor, constitute "actual fraud."[56] With provisions like the good faith defense, a finding of actual fraud not only heightens the burden of proof that the defendant must carry in order to demonstrate that his or her actions were legitimately in good faith, but also increases the amount of the claim that can be recovered from the defendant as a fraudulent or preferential transfer.[57] With other provisions, like the stockbroker defense, a finding of actual fraud removes availability of the defense altogether. A finding of actual fraud, therefore, can greatly impact not only how much a party is protected by a

[56] 11 U.S.C. § 548(a)(1)(A) (2005) (defining an actually fraudulent transfer as one made with "actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted").

[57] In a claim for a constructively fraudulent transfer, the debtor need not display an actual intent to defraud creditors for a court to find the transfer constructively fraudulent. *See* 11 U.S.C. § 548(a)(1)(B). Notably, some courts have found that in constructively fraudulent cases, because actual intent is not proven, creditors may assert a claim for restitution of their principal investments if given in subjective good faith. Contrast this to a claim for actual fraud, *see* 11 U.S.C. § 548(a)(1)(A), where the estate is entitled to all sums of the investment including principal unless the creditor can prove objective good faith. *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 177-78 (1998) ("[T]he distinction [between actual fraud and constructive fraud] has important consequences in practice. If the trustee pursues only a constructive fraud theory (showing a transfer to an investor at a time when the debtor had insufficient funds), the *investor can retain any repayment of principal by asserting that he did not actually know of the debtor's fraud.* But, if the trustee proceeds on a case of intentional fraud (i.e., proving the operation of a Ponzi scheme), the estate will be entitled to recover *all sums paid to the investor* unless the investor is able to prove his objective good faith.") (emphasis added).

safe harbor, but in certain instances, whether the party is protected at all.[58]

In making a determination of actual fraud, a court will look primarily to see whether the actions taken by the debtor evince an "actual intent to hinder, delay, or defraud" his or her creditors.[59] Sometimes this determination is relatively clear-cut.[60] There are conspicuous signs, either of fraud or some other type of impropriety, that unmistakably show that the debtor was deliberately attempting to engage in fraudulent activity.[61] When these findings are made, it makes sense for courts to refuse to extend any protections to the guilty parties.[62] In other instances, however, the determination is not obvious at all. In these cases, courts are

[58] *Compare* Jobin v. Cervenka, 194 B.R. 496, 502 (D. Colo. 1996) (holding that a subjective, not objective, test of culpable knowledge should be applied in constructive fraud actions to determine whether a claim for restitution should stand) *with* Kendall v. Turner, 335 B.R. 140, 145 (Bankr. N.D. Cal. 2005) (holding that an avoidance under Section 548(a)(1)(A) results in the entire amount being avoided, not just the excess over the consideration given in good faith).

[59] 11 U.S.C. § 548(a)(1)(A) (2005); *see* Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 63 (1991) ("Classic fraudulent conveyance law is concerned with a debtor who manipulates his assets so as to keep them from his creditors. When a debtor is insolvent and must hand his assets over to his creditors, he has an incentive to hide his assets, to gamble them away, or to cut the best possible deal with a friend (whether or not the friend is his creditor). These types of actions form the core behavior that classic fraudulent conveyance law is designed to prevent.").

[60] *See, e.g.*, Ford v. Poston, 773 F.2d 52 (4th Cir. 1985) (debtor conveyed real property to himself and his wife, as tenants by the entirety, to shield property from execution by judgment creditors); Lefkowitz v. Finkelstein Trading Corp., 14 F. Supp. 898 (S.D.N.Y. 1936) (debtor arranged for a friend to purchase his property at a foreclosure sale at a price substantially below its true value).

[61] *See* Williams, *supra* note 59, at 59 ("The law imposes a substantive prohibition—the debtor may not dispose of its property with the intent, actual or implied by law, of placing the property beyond the reach of its creditors.").

[62] *See* Kipperman v. Circle Trust (*In re* Grafton Partners L.P.), 321 B.R. 527, 529 (B.A.P. 9th Cir. 2005) (nullifying a private transaction concerning the sale of illegal, unregistered securities).

often asked not merely to judge the parties' actions but also their intentions, forcing them to engage in a much trickier analysis.[63] The court's decision to find fraud and subsequently refuse many of these protections becomes infinitely more problematic.[64]

Therefore, while the actual fraud exception to the safe harbors appears, at first glance, to have a meaningless effect on parties that attempt to act properly, it actually becomes quite significant. In retaining the right to assess the parties' actions, courts become the ultimate arbiter in the bankruptcy process.[65] By enlarging or restricting the definition of actual fraud, courts are able to wield considerable influence on the use and availability of the safe harbors, notwithstanding Congressional efforts to limit their involvement otherwise.[66] Moreover, while the implications of actual fraud suggest a bright line requirement that there be some overt indication of impropriety or bad faith, it is clear that courts have not typically adhered to such a stringent standard.[67]

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[63] *See* McDermott, *supra* note 57, at 175 (arguing that a blanket presumption of fraud is only appropriate "where it is unmistakable that the debtor purposefully orchestrated a scheme which, by its very design, could only serve to defraud investors").

[64] *See id.*

[65] *See* discussion *infra* Parts III.A.1 (using fraud to shape the stockbroker defense) and III.B.1 (using fraud to shape the good faith defense).

[66] *See* Morrison & Riegel, *supra* note 13, at 644 (positing that Congress deliberately attempted to prevent courts from becoming too involved in the interpretive process).

[67] Jobin v. McKay (*In re* M&L Bus. Mach. Co.), 155 B.R. 531, 539-40 (Bankr. D. Colo. 1993) (holding that a court may rely on circumstantial evidence in support of finding of actual intent), *aff'd*, 84 F.3d 1330 (10th Cir. 1996). This is possibly because the burden of showing intentional fraud is simply too high a standard for parties to meet. *See* Christopher J. Redd, *Treatment of Securities and Derivatives Transactions in Bankruptcy*, 24 AM. BANKR. INST. J. 36, 56 (2005) (explaining that courts often resort to circumstantial evidence to negate transactions that appear to be fraudulent rather than look for clear proof because, in all likelihood, it is either too difficult to obtain or just not available).

III. LIMITING THE SAFE HARBOR PROVISIONS BY EXPANDING FRAUD

There are two specific ways courts have used fraud to shape the protections traditionally afforded by the safe harbors. The first is by simply broadening the definition of what constitutes actual fraud by incorporating a presumption of actual fraud to certain activities. Part III.A discusses the emergence of one of these "presumptively fraudulent" transactions—Ponzi schemes—and argues that courts, in aggressively deeming more and more failed investments to be Ponzi schemes, are adversely affecting counterparties' rights in a manner that clearly contravenes Congressional intent. The second way courts use fraud to shape the bankruptcy process is by imposing additional duties on a party once a transaction has been deemed fraudulent. Part III.B discusses the emergence of one such court-manufactured requirement, the duty of diligence, and examines how its addition to a good faith assessment potentially stands to upset many of the policies set forth by Congress.

A. Ponzi Schemes and Their Emergence in Bankruptcy Law

The term Ponzi scheme refers to a fraudulent arrangement where an entity that has little to no capital creates an illusion of profitability without actually generating any profits.[68] The heart of the scheme is a

[68] The term "Ponzi scheme" is coined after Charles Ponzi, an Italian immigrant who became notorious for using the scheme with great success in the 1920s. While not being the first to use such a scheme, Charles Ponzi's meteoric rise from a relatively obscure salesman to a well-known Boston millionaire in less than six months made him synonymous with these "get rich" schemes that prey on naïve investors. For more information on the collapse of Charles Ponzi's fraudulent investment program, see Cunningham v. Brown, 265 U.S. 1, 7-9 (1924); Harbeck & Caplan, *Work for a Ponzi Scheme – and Keep Your Commissions?*, 13 J. BANKR. L. & PRAC. 5., art. 1 & n.1 (citing *In re* United Energy Corp., 944 F.2d, 589, 590 n.1 (9th Cir. 1991)).

deliberate lack of a legitimate underlying business venture; the scheme works by distributing proceeds from new investors to old investors as "profits," thereby creating an illusion that a legitimate profit-making business exists.[69] Typically, the business is able to continue because the larger than life returns that earlier investors receive attract new investors and thus new capital.[70] Though brief in duration, these schemes are able to generate enormous amounts of revenue because there are no overhead expenses to absorb any of the incoming cash flow.[71] Ponzi schemes often end as abruptly as they begin, usually collapsing from one of two events: too many investors seeking their returns at one time or the scheme simply failing to recruit new capital.[72]

Most courts have held that the finding of a Ponzi scheme creates a presumption of actual fraud as a matter of law on all parties and transactions involved.[73] Significantly, this translates to an automatic determination that "enterprises operating Ponzi schemes are, by definition, insolvent from

[69] *In re* Churchill Mortgage Inv. Co., 256 B.R. 664, 667 n.2 (citing Merrill v. Abbott (*In re* Indep. Clearing House Co.), 41 B.R. 985, 994 n.12 (Bankr. D. Utah 1984)).

[70] *Id.*

[71] *See* McDermott, *supra* note 57, at 175. For further discussion on the origin of Ponzi schemes, see Balabar-Strauss v. Lawrence, 264 B.R. 303, 305-06 (S.D.N.Y. 2001).

[72] *See* Harbeck & Caplan, *supra* note 68, art.1 & n.1.

[73] Numerous courts have held "that when a trustee establishes that a debtor has operated a Ponzi scheme, the debtor's actual intent to hinder, delay, or defraud his creditors is established as a matter of law." McDermott, *supra* note 57, at 173. *See, e.g.*, Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 860 (D. Utah 1987) ("A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors . . . . He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent in the eyes of the law, and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.").

the start."[74] This is especially important for financial counterparties like prime brokers because it suddenly renders any payment made by the debtor, even those protected by safe harbors, susceptible to a fraudulent or preferential transfer claim.[75] Importantly, even transactions which took place before the allegedly improper acts occurred will be considered presumptively fraudulent.[76]

While this all or nothing rule makes sense in situations that qualify as classic Ponzi schemes, such a blanket presumption becomes problematic where it is not clear that the debtor began with a fraudulent purpose[77] and where the mechanics of the debtor's behavior do not obviously resemble a traditional Ponzi scheme.[78] For example, a debtor may run a legitimate business operation that, through no fault of his or her own, becomes overextended. In an effort to keep the business afloat, the debtor may be forced to take some risks. He may begin making promises to investors and creditors that the debtor knows may not be honored. The debtor may also be forced to engage in less desirable practices like transferring funds from new investors to old investors or bank borrowings from one lender to another lender in order to make ends meet. Ultimately, the debtor's gambles may

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[74] Francis Morrisey, *Failed Hedge Funds: 2 Cheers for Liquidation in Bankruptcy*, Edwards Angell Palmer & Dodge Memorandum, at 7 (2007) (on file with author); *see also In re* Taubman, 160 B.R. 964, 986 (Bankr. D. Ohio 1993) ("The nature of a Ponzi scheme renders the operator insolvent from the beginning.").

[75] *See* Morrisey, *supra* note 74, at 7.

[76] *See* Scholes v. Lehman, 56 F.3d 750, 757 (7th Cir. 1995) (holding that an inference of fraud is drawn whenever Ponzi scheme is determined to have occurred); Hayes v. Palm Seedlings Partners (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 535 (9th Cir. 1990) (holding that a debtor's actual intent can be inferred from the mere existence of a Ponzi scheme).

[77] Recall that one of the essential elements of a classic Ponzi scheme was the lack of a legitimate underlying business venture. *See supra* text accompanying note 69.

[78] *See* McDermott, *supra* note 57, at 175 (arguing that the presumption of fraud should be limited "to situations where it is unmistakable that the debtor purposefully orchestrated a scheme which, by its very design, could only serve to defraud investors").

never pay off and the entire business may end up hopelessly insolvent. While some of the debtor's actions, like the recycling of debt, bear some resemblance to the operation of traditional Ponzi schemes, it is hardly accurate to label the operation a true Ponzi scheme.[79]

1. Effect of Ponzi Schemes on the Stockbroker Defense

For prime brokers and other financial participants typically protected in the Code, a judicial finding that a Ponzi scheme exists results in serious consequences. First, it means that any transaction or contract with the debtor's business is now deemed "actually fraudulent," regardless of intent.[80] Second, because the entire operation is now implicated, these parties automatically lose many of the safe harbors they believed would have been available when they first entered into the transaction.[81] *Manhattan Investment Fund* is a good illustration of the impact that a Ponzi scheme finding has on a financial participant and how this ultimately affects the party's ability to assert the stockbroker defense.[82]

In *Manhattan Investment Fund*, Bear Stearns served as the hedge fund's prime broker, clearing and settling trades

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[79] *See id.* at 174 ("Where a legitimate business operation has been in existence, it is not clear whether the debtor should be deemed to have been operating a Ponzi scheme.").

[80] *See* Terry v. June, 432 F. Supp. 2d 635, 639 (W.D. Va. 2006) ("[C]ourts have widely found that Ponzi scheme operators necessarily act with actual intent to defraud creditors due to the very nature of their schemes."); Bauman v. Bliese (*In re* McCarn's Allstate Fin., Inc.), 326 B.R. 843, 850 (Bankr. M.D. Fla. 2005) ("Bankruptcy courts nationwide have recognized that establishing the existence of a Ponzi scheme is sufficient to prove a [d]ebtor's actual intent to defraud.").

[81] *See supra* note 56. Recall that 11 U.S.C. § 546(e) (2005) has an exception where a showing of actual fraud automatically prevents a creditor from asserting a safe harbor to prevent avoidance by the debtor.

[82] *See* Gredd v. Bear, Stearns Sec. Corp. (*In re* Manhattan Inv. Fund Ltd.), 359 B.R. 510 (2007).

for the offshore investment fund's short-selling strategy.[83] Though properly formed and capitalized at the outset, the Fund's principal, Michael Berger, made several poor investment decisions that had costly results, eventually bringing the Fund to financial ruin.[84] At trial, the court found Berger liable for several counts of securities fraud after he admitted to misrepresenting the Fund's performance to investors once it was clear that the Fund was losing money.[85] Significantly, however, the court determined that Bear Stearns played no part in Berger's fraud.[86] In fact, the court went on to dismiss all actions against the prime broker for any improper conduct at the pleading stage.[87]

Despite affirming Bear Stearns' lack of contribution to the fraud, the court nevertheless held that Berger's actions were alone sufficient to find the entire operation a Ponzi scheme.[88] As a result, all of the Fund's transfers, including those to innocent financial counterparties like Bear Stearns, became presumptively fraudulent as a matter of law.[89]

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[83] *See supra* note 37. To close out its short positions, the Fund would direct Bear Stearns to repurchase the stocks and return them to the lenders. However, because Bear Stearns had originally borrowed the stocks and not the Fund, Bear Stearns was the party that ultimately had the obligation to return the stocks while the Fund had open short positions. In this way, as with most prime broker arrangements, Bear Stearns, and not the Fund, bore the actual risk if the Fund ended up failing to cover. Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452, 469 (S.D.N.Y. 2001).

[84] *See* Bear, Stearns Sec. Corp. v. Gredd, 275 B.R. 190, 191 (2002) ("The principal strategy of the Fund was to sell short technology and Internet-related securities that its manager, Michael Berger, believed to be overvalued.").

[85] *See id.*

[86] Cromer Fin. Ltd., 137 F. Supp. 2d at 469-72.

[87] A lawsuit tying Bear Stearns to the fraud through an aiding and abetting claim was dismissed at the pleading stage. *See id.*

[88] *See* Gredd v. Bear, Stearns Sec. Corp. (*In re* Manhattan Inv. Fund Ltd.), 359 B.R. 510, 519 (2007).

[89] *See id.* at 518 ("Moreover, acts taken in furtherance of the Ponzi scheme, such as paying brokers commissions, are also fraudulent . . . . In light of Berger's guilty plea and conviction coupled with the fact that the margin payments were made in connection with a massive Ponzi scheme,

Accordingly, the court authorized the estate to recover nearly $141.4 million in margin payments made to Bear Stearns during the previous year.[90] The court allowed the recovery of these payments despite the fact that at all times the payments were deemed to be in accordance with federal regulations[91] and the Fund's own prime brokerage agreement with Bear Stearns.[92]

Manhattan Investment Fund is a good example of how a party's rights can be adversely affected by a loose judicial interpretation of a Ponzi scheme. The courts determined that a prime broker acted properly; yet, because of a Ponzi scheme, the broker lost its ability to assert the key safe harbor provision that would have protected it, the stockbroker defense.[93] This shows the damage that can occur to innocent counterparties when courts are willing to depart

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this Court finds sufficient evidence of actual fraudulent intent in connection with the Transfers.").

[90] In order to provide brokerage services, Bear Stearns required the fund to keep a margin account with Bear Stearns that ensured that some capital would remain with Bear Stearns to cover any of the fund's open short positions. *See* Bear, Stearns Sec. Corp. v. Gredd, 275 B.R. at 197. This is standard practice for nearly all prime brokers in an effort to partially mitigate the risk that the broker will end up having to cover any open positions that are never covered by the fund. *See* Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841, 845 (1993) [hereinafter Minnerop, *Role and Regulation*].

[91] Under Regulation T of the Board of Governors of the Federal Reserve Board, Manhattan Investment Fund was required to deposit into its margin account fifty percent of the value of any short positions that were opened on a given day. *See* Bear, Stearns Sec. Corp. v. Gredd, 275 B.R. at 197 (citing 12 C.F.R. § 220.12(c)(1)).

[92] Bear Stearns had its own "house" margin requirement of thirty-five percent where the fund was obligated to maintain an amount equal to thirty-five percent of the value of its open short positions on deposit in its margin account at Bear Stearns at all times. Although this requirement was five percent above the independent thirty percent requirement for short sales set by the National Association of Securities Dealers, Inc. ("NASD"), it is industry custom for brokerage firms to enforce margin requirements in excess of the minimum NASD requirement. *See In re* Manhattan Inv. Fund Ltd., No. 07-2511, slip op. at 1 & n.4 (S.D.N.Y. Dec. 17, 2007).

[93] *See supra* notes 56, 81 and accompanying text.

from a consistently rigid standard in evaluating whether failed business ventures are actually Ponzi schemes that would fit the classic definition.[94] The stockbroker defense was clearly designed to promote stability within the financial industry; by applying blanket presumptions loosely, courts not only ignore this purpose but they actually stand to harm innocent parties that acted in reliance on this safe harbor.[95]

Moreover, by imputing fraud to transactions that are otherwise legitimate, courts remove predictability for important players in the financial marketplace.[96] Arguably, the chief goal of Congress in mirroring non-bankruptcy and bankruptcy rights is to provide clarity and promote stability.[97] Without the assurance of these protections, parties may not enter into transactions that are beneficial for the market because of the added risks that a bankruptcy proceeding now creates. By retaining a powerful voice in the assessment of which transactions and contracts are afforded safe harbor, courts have become a significant part of the interpretive process—a result that Congress presumably tried to prevent with its 2005 amendments.[98]

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[94] Recall that the court deemed Berger's choice to bet against a rise in technology stocks a serious miscalculation of investment strategy, never going so far as to say that Berger began the Fund with intent for the Fund to fail. SEC v. Berger, 322 F.3d 187, 188 n.1 (2d Cir. 2003) ("Berger chose this investment strategy because *he believed that the stock market in general, and particularly technology stocks, were overvalued.* Because the stocks he sold short continued to climb in value, however, the Fund suffered substantial losses.") (emphasis added).

[95] *See supra* notes 30-39 and accompanying text.

[96] *See* Timothy A. Barnes, *Sections 548 and 550 - Recent Developments in the Law of Fraudulent Transfers and Recoveries*, 2007 ANN. SURV. OF BANKR. LAW, Part III § 31, p. 6 (Sep. 2007) ("As noted by the FDIC, 'these changes will *reduce systemic risk by providing greater clarity to the rights available to larger participants* in markets.'") (citing FDIC, Oct. 11, 2005, Update on Emerging Issues in Banking, *available at* http://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html) (emphasis added).

[97] *See id.*

[98] *See* Morrison & Riegel, *supra* note 13, at 642–44.

B. The Good Faith Defense and its Requirements

Another important safe harbor that courts can greatly influence is the good faith defense. The good faith defense was created to protect parties that innocently transact with debtors.[99] Unlike the stockbroker defense, the good faith defense is expressly made available to counterparties even in instances of actual fraud.[100] Accordingly, this defense is typically asserted by a party to protect a transaction that is being challenged by the bankruptcy estate as a fraudulent transfer.[101] Notably, because the good faith defense is available in cases of actual fraud, a judicial determination that the debtor's overall strategy is a Ponzi scheme does not automatically remove the availability of the good faith defense.[102]

To receive protection under 11 U.S.C. § 548(c), which codifies the good faith defense, a defendant must make a prima facie showing of two threshold elements: (1) the underlying transfer was made "for value;"[103] and (2) the defendant's actions were in "good faith."[104] While there is no

[99] *See* Bassano et al., *supra* note 32, § 2058 (stating the policy behind good-faith defense is to "protect certain innocent purchasers from challenges to the underlying transfer").

[100] 11 U.S.C. § 548(c) (2005) ("A transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.").

[101] *Id.* § 548(a)(1)(A); *see supra* note 57 and accompanying text.

[102] *See* McDermott, *supra* note 57, at 175 ("If a trustee succeeds in showing that an investor received a transfer from the debtor as part of an intentionally fraudulent Ponzi scheme, the investor may be able to retain at least some of the transferred funds under a good faith defense.").

[103] *See* Bassano et al., *supra* note 32, at § 2058 ("The 'value' required to be paid by the transferee is merely consideration sufficient to support a simple contract; there is no requirement that the value given by the transferee be a reasonable or fair equivalent.").

[104] *See* Harbeck & Caplan, *supra* note 68, art. 1 at 2 ("In applying section 548(c), courts have uniformly placed the burden of proving both: (i) good faith; and (ii) value upon the defendant [transferee]. Without both elements, the section 548(c) defense will necessarily fail.").

explicit definition of good faith in the Bankruptcy Code, courts have concluded that the proper measure for determining whether a transferee has carried this burden is through an *objective* rather than *subjective* analysis.[105] In this context, courts essentially determine whether the defendant has exercised a reasonable duty of care when entering into the underlying transaction.[106] If he has, then the defendant has carried the burden necessary to invoke the defense; however, if he has not (e.g., the defendant asserted a *genuine* but *unreasonable* belief), then the defense is unavailable.[107]

While the courts have uniformly held that the good faith standard to be applied is objective, this by no means ends the analysis.[108] Ultimately, the courts still have to determine how this standard should be applied.[109] Thus, while invoking a good faith defense appears to be a relatively straightforward two-step process, the assessment actually

[105] An objective analysis looks to see whether the transferee should have known that the challenged transaction was fraudulent while a subjective analysis tests whether the transferee actually knew of the fraudulent activity. Jobin v. McKay (*In re* M&L Bus. Mach. Co.), 84 F.3d 1330, 1338 (10th Cir. 1996) (stating that the good faith assessment under Section 548(c) should be measured objectively).

[106] *See* McDermott, *supra* note 57, at 176.

[107] *See id.* ("An investor, therefore, cannot meet his burden merely by testifying that he did not have an actual, subjective knowledge that the debtor was operating a Ponzi scheme . . . .").

[108] *See* Young, *supra* note 31, at 876 ("Good faith in this context is difficult to define precisely, and it depends on the circumstances of each case."); *see also* McDermott, *supra* note 57, at 176 (arguing that a good faith assessment should be assessed with respect to each transaction).

[109] Courts are inconsistent in determining how to approach the good faith defense when there is a finding of a Ponzi scheme. *See* Young, *supra* note 31, at 877. Some refuse to extend the defense to any party involved with the debtor because any transaction that furthers this illegal activity offers no value and only deepens the debtor's insolvency. *See In re* Randy, 189 B.R. 425, 440-43 (Bankr. N.D. Ill. 1995). In contrast, other courts have allowed the defense in such situations because they believe that a party who acted without knowledge of the scheme should not be held to have furthered an illegal enterprise. *See In re* Fin. Federated Title & Trust, Inc., 309 F.3d 1325, 1332-33 (11th Cir. 2002).

becomes much more complicated. *Manhattan Investment Fund* again serves as a good example of the difficulties facing courts when they are asked to determine how best to apply this good faith assessment.

1. Due Diligence and its Effect on the Good Faith Defense

As mentioned previously, *Manhattan Investment Fund* involved the collapse of a hedge fund run by Michael Berger.[110] In addition to ruling that the Fund's margin payments to the prime broker (Bear Stearns) were fraudulent transfers,[111] the Bankruptcy Court found that the prime broker could not assert a good faith defense because it was on inquiry notice and failed to adequately investigate signs that the debtor may have been engaging in fraudulent activity.[112] While the idea of inquiry notice is by no means a foreign concept to courts when assessing whether a transferee has acted objectively in good faith,[113] this new

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[110] *In re* Manhattan Inv. Fund Ltd., 359 B.R. 510, 513 (Bankr. S.D.N.Y. 2007).

[111] *See supra* notes 83-92 and accompanying text.

[112] The court found several incidents conclusive in finding that Bear Stearns was on "inquiry notice" and failed to adequately investigate: (1) a senior director for Bear Stearns heard inconsistent information about the Fund's performance at a cocktail party (essentially, the investor stated that the fund was reporting a twenty percent profit despite the director's own belief that the Fund was actually losing money); (2) Bear Stearns asked Berger, the fund manager, about the discrepancy and did not verify the veracity of his information (Berger claimed that the discrepancy resulted from Bear Stearns' being one of several prime brokers the Fund used although it was not); (3) Bear Stearns did not notify the SEC of fraud until nearly a year later when it determined, after receiving information from a former marketer of the Fund that Berger had a checkered history in breaching contractual arrangements. (Manhattan Inv. Fund), 359 B.R. at 525-26 ("It is clear from the record that Bear Stearns was on inquiry notice of Berger's fraud . . . . Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong.").

[113] *See In re* World Vision Entm't, Inc., 275 B.R. 641, 659-60 (Bankr. M.D. Fla. 2002) (quoting *In re* Cannon, 230 B.R. 546, 592 (Bankr. W.D. Tenn. 1999), *rev'd on other grounds*, 277 F.3d 838 (6th Cir. 2002) (finding that a transferee may not remain willfully ignorant of facts that would

requirement that Bear Stearns, as the prime broker, prove good faith by also demonstrating that it had conducted due diligence introduced a heightened and investigative component not required by a majority of other courts.[114] Even more interesting is that the court added this requirement notwithstanding the dismissal at the pleading stage of all counts against Bear Stearns for acting improperly or otherwise fraudulently.[115]

For prime brokers like Bear Stearns, this ruling raises serious questions about what steps it should have or could have taken to appease the court.[116] For example, would it have been sufficient for Bear Stearns to have taken more steps to seek out the fraud or did the broker actually have to uncover the fraud? What about the court's determination that Bear Stearns had not acted in a timely manner?[117]

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otherwise cause it to be on notice of a debtor's fraudulent purpose by wearing "blinders" and entering into the transaction)); *In re* Sherman, 67 F.3d 1348, 1355 (8th Cir. 1995) ("[A] transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency.").

[114] *Compare* (Manhattan Inv. Fund), 359 B.R. at 526-27 ("Bear Stearns *failed to act diligently in a timely manner* and accordingly, Bear Stearns cannot satisfy its burden of showing that it acted *with the diligence required* to establish good faith . . . .") (emphasis added) *with* 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) (finding that a prime broker owed plaintiff hedge fund investors no duty "to monitor, verify, or investigate the veracity of the information disseminated by" the hedge fund manager); Sharp Int'l Corp. v. State Street Bank & Trust Co., 403 F.3d 43, 52-53 (2d Cir. 2005) (holding that the creditor bank had no duty to investigate or "protect lenders that were less diligent" when accepting transfers from the debtor on a previous bank loan that was legitimately disbursed).

[115] Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452, 470-72 (S.D.N.Y. 2001) (dismissing Manhattan Fund investors' claims that Bear Stearns aided and abetted Michael Berger by allowing him to continue trading on Bear Stearns' credit).

[116] BARRY E. ADLER ET AL., BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 351 (4th ed. 2007) (noting the cyclical reasoning of the court in making its conclusion that Bear Stearns was liable).

[117] (Manhattan Inv. Fund), 359 B.R. at 526-27 ("The simple steps Bear Stearns finally performed one year [after first questioning Berger],

Perhaps more importantly, it also creates an unnecessarily large amount of confusion for all other interested parties who now must speculate whether their actions will be deemed adequate in the future.[118]

The creation of an affirmative duty of due diligence becomes even more problematic when viewed in light of the underlying policy arguments behind safe harbor provisions.[119] To the extent that safe harbors are designed to protect significant financial players like prime brokers from systemic industry risks, it makes little sense for courts to take an active role in aggressively limiting these protections.[120] By imposing additional responsibilities on financial counterparties that have otherwise acted properly, courts end up excluding defendants that may have legitimately deserved shelter under the good faith defense.[121]

Additionally, if the ultimate purpose of these provisions is to provide stability and clarity by ensuring that financial contracts, transactions, and participants have identical sets of rights in and out of bankruptcy, the creation of an affirmative duty for prime brokers to investigate clearly misses the mark.[122] Outside of bankruptcy, it is well settled that prime brokers have no supervisory or investigative

demonstrate that Bear Stearns failed to act diligently in a timely manner and accordingly, Bear Stearns cannot satisfy its burden of showing that it acted with the diligence required to establish good faith . . . .").

[118] Harbeck & Caplan, *supra* note 68, art. 1, at 2 ("[T]o hold that certain employees tangentially involved in the scheme may invoke section 548(c) while those who are directly involved, albeit unknowingly, may not invoke the defense creates a capricious dichotomy. Furthermore, it imposes additional and unnecessary burdens by requiring the judiciary to determine at what point an employee's efforts morph into actions perpetuating a Ponzi scheme.").

[119] *See* Morrison & Riegel, *supra* note 13, at 642.

[120] *See id.*

[121] Recall that Bear Stearns was not found liable for contributing to the fraud. *See supra* notes 87, 91-92, 115 and accompanying text.

[122] *See* discussion *supra* Parts II.A (explaining the importance of clarity and consistency to reduce risks) and II.B (explaining the well-established duties of prime brokers in a non-bankruptcy context).

obligations.[123] Their chief responsibility is providing back office functions that do not regularly bring them into contact with customers.[124] It is odd to create an entirely different set of obligations for a prime broker simply because the bankruptcy process has been initiated.[125] This essentially forces a broker to pick its own poison by choosing between two arbitrarily imposed standards—one inside bankruptcy, where it would have to internalize the extra costs of having to investigate every party to a transaction, and one outside bankruptcy, where it would be able to act in accordance with non-bankruptcy laws but would then have to roll the dice, hoping that bankruptcy never occurs.[126]

Lastly, from a legal process perspective, it is unwise to give courts discretion in allocating duties among market participants like prime brokers when the industry is much

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[123] *See* Brief for Appellant at 5 & n.2, *In re* Manhattan Inv. Fund, 359 B.R. 510 (S.D.N.Y. 2007) (No. 07-02511) [hereinafter WLRK brief] (on file with author) ("[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 transactions they are processing.") (citing N.Y.U.C.C. § 8-102(A) cmt. 10); *see also* Minnerop, *Clearing Arrangements*, *supra* note 43, at 925 ("Typically, the customer agreement between the clearing firm and the customer will authorize the clearing firm to accept instructions and orders from the introducing firm for the customer's account *without inquiry or investigation*, unless the clearing firm receives prior written notice from the customer to the contrary.") (emphasis added).

[124] *See supra* notes 46, 48 and accompanying text; *see also* discussion *supra* Part II.B.

[125] *See* Minnerop, *Role and Regulation*, *supra* note 90, at 851 ("Clearing firms play no direct or personal part in the customer's relationship with his or her [introducing] broker. The clearing firm's involvement takes the form of processing and clearing transactions after they have occurred. In brief, the clearing brokers' functions may be characterized as value neutral. In performing clearing functions in connection with allegedly fraudulent transactions, clearing brokers do nothing more or less than what they routinely do with respect to all transactions.").

[126] *See supra* notes 48-54 (discussing lack of affirmative duty to investigate for prime brokers), Part II.A (discussing importance of stability for financial markets).

better equipped to handle this type of decision.[127] In the case of a prime broker, a poor decision by the courts has the potential to disrupt an entire system of efficient clearing and trading that Congress and the Securities and Exchange Commission ("SEC") have worked so hard to create.[128] The adverse effects could be disastrous.[129] By forcing prime brokers to engage in expensive, time-consuming supervisory activities, courts are threatening the efficient division of labor on which the securities industry thrives.[130]

IV. TWO BRIGHT LINE RULES FOR SAFE HARBOR PROVISIONS TO REMAIN EFFECTIVE

Because of the dangers that can arise when judicial interpretations stray from the clearly established policies behind the stockbroker defense and the good faith defense, courts should adopt two bright line rules that will create consistency and clarity for both courts and financial counterparties. First, in evaluating whether a Ponzi scheme exists, courts should only take an ex ante approach. This would prevent courts from engaging in hindsight analysis that could cloud their judgment or force them to engage in difficult line-drawing. This rule would also minimize collateral damage on innocent counterparties by ensuring that only those enterprises that fit the classic definition of a Ponzi scheme are deemed presumptively fraudulent. Second, courts should use industry norms in determining whether a party's actions allow the use of a good faith

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[127] Minnerop, *Clearing Arrangements*, *supra* note 43, at 917-18.

[128] *See id.*

[129] "The [prime brokerage and clearing] system routinely processes the multi-billion share trading volumes that characterize current securities markets. Without this highly efficient clearance and settlement system, modern securities markets simply could not function. The structure and success of this system is no accident. Its regulatory contours, including the role and regulation of clearing brokers, have been shaped by *federal regulatory actions and policies that have encouraged the non-duplicative allocation of operational and regulatory responsibilities for the ultimate benefit of investors.*" *Id.* at 958 (emphasis added).

[130] *Id.*

defense. This will protect the stability of the financial markets by ensuring that parties can reliably gauge their obligations in and out of bankruptcy. The rule would also prevent courts from playing too large a role in the decision-making and duty-allocation processes that should be left to the market.

A. An Ex Ante Approach to Ponzi Schemes

The first proposed bright line rule would require courts to evaluate Ponzi schemes on a strict ex ante basis. Because a finding of a Ponzi scheme results in a blanket presumption of fraud on parties, contracts, and transactions to the scheme,[131] a strict ex ante approach ensures that courts are consistent in applying their evaluations. More importantly, this consistency prevents innocent parties from being unfairly denied safe harbor protections. Originally, a Ponzi scheme consisted of several fundamental elements: (1) a deliberate lack of a legitimate underlying business model; (2) utterly inadequate or disproportionate capitalization (debt to asset ratio) of the business operations; and (3) a clear intent to defraud and victimize new or naïve investors through false accounting, advertising or other means of deception.[132] Over time, however, courts have chosen to broaden this definition, labeling many failed investment ventures Ponzi schemes despite their lack of one or more of these crucial elements.[133]

[131] *See* discussion *supra* Part III.A.1 (noting the serious effects of a Ponzi scheme finding).

[132] *See* discussion *supra* Part III.A (noting the traditional elements of a Ponzi scheme).

[133] Many courts have departed from the traditional tripartite Ponzi analysis, choosing instead to find that proof of the debtor recycling funds is alone sufficient to label an entire operation a Ponzi scheme. This is dangerous for the reasons expressed *supra* in Part III.A (arguing that in these instances, a blanket presumption of fraud may not be warranted). *See* Hayes v. Palm Seedlings Partners (*In re* Agric. Research and Tech. Group, Inc.), 916 F.2d 528, 536 (9th Cir. 1990) ("Distributing funds to earlier investors from the receipt of monies from later investors is the hallmark of Ponzi schemes."); *In re* Bayou Group LLC, 362 B.R. 624, 633 (S.D.N.Y. 2007) ("[The creditor's] restricted definition of 'a true Ponzi scheme' (promise of high returns, no legitimate underlying business

While this liberal, more aggressive approach is reasonable in clear instances where fraud or intent to deceive can be properly inferred, it becomes questionable in close cases where the presumption of misdealing is much less apparent.[134] Arguably, in these instances, it makes sense to limit the application of the actual fraud presumption.[135]

A rule that forces courts to examine the actions and intent of the debtor ex ante provides all interested parties with several advantages. First, it curbs the danger that courts, when entering into an ex post analysis, will be unfairly prejudiced by the massive fallout typically accompanying a fund collapse. The heart of a true Ponzi scheme is that the debtor acts with intentions that are either actually fraudulent, or at the very least, so irrational as to be considered constructively fraudulent.[136] By preventing a hindsight analysis, courts can act with more objectivity. This also creates the added benefit of protecting the reasonable expectations of potential parties like prime brokers because it gives them a fairly stable framework for mitigating the risk of entering into a particular transaction or contract. By understanding when and how their

activity and the certainty that later investors cannot possibly be repaid) does not accord with the case law . . . the label 'Ponzi scheme' has been applied to *any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors* . . . .") (emphasis added); Cuthill v. Kime (*In re* Evergreen Sec., Ltd.), 319 B.R. 245, 249 (Bankr. M.D. Fla. 2003) (finding a Ponzi scheme existed where the debtor "used most funds received from new investors to pay prior investor claims").

[134] *See supra* notes 77-79 and accompanying text.

[135] One court agreed with this notion, finding that a presumption of actual fraud to all parties involved with a Ponzi scheme led to inequitable results. There, the court held that the broker's commissions were not fraudulent conveyances because the specific transactions challenged (payment of commissions) were not fraudulent and the broker displayed no fraudulent intent. *In re* Churchill Mortgage Inv. Co., 256 B.R. 664, 681 (S.D.N.Y. 2000) ("The fact that the debtor's enterprise as a totality is operated at a loss, or in a manner that is fraudulent, does not render actually or constructively fraudulent a particular transaction which in and of itself is not fraudulent in any respect.").

[136] *See supra* notes 68-72 and accompanying text.

protections under a key defense like the stockbroker defense will be evaluated by the court, prime brokers can more accurately and efficiently ascertain which contracts, transactions, and debtors present safer and more desirable opportunities than others.

Second, this rule reinforces the policy behind the actual fraud exception. Congress created an express carve-out from the safe harbors to ensure that parties engaging in fraudulent activities could not seek protection.[137] Presumably, this was because actual fraud required a showing that a party acted with clear intent and purpose; hence, Congress sought to deny these parties safe harbors because their actions were clearly fraudulent.[138] In the same way, a classic Ponzi scheme qualified as an example of actual fraud because the hallmark of such a scheme was a deliberate lack of a legitimate underlying business model and clear intent to run a hollow enterprise.[139] Thus, the blanket presumption of fraud that courts attached was both warranted and factually supported.[140] Over time, however, courts have become more liberal in deeming failed businesses Ponzi schemes despite the lack of one or more traditional Ponzi elements.[141] In these situations, it is not so obvious a Ponzi scheme even existed; therefore it is not so

[137] *See supra* notes 59-62 and accompanying text.

[138] *See supra* notes 56, 59-62 and accompanying text.

[139] *See supra* note 133 and accompanying text (discussing the original elements of a Ponzi scheme); *see also* Part III.A.

[140] *See In re* World Vision Entm't, Inc., 275 B.R. 641, 659 (Bankr. M.D. Fla. 2002) ("[A] transferee may not remain willfully ignorant of facts which would cause it to be on notice of a debtor's fraudulent purpose . . . [and then] put on blinders prior to entering into transactions with the debtor."); *see also* McDermott, *supra* note 57, at 175 (noting certain situations where a fraudulent presumption would be appropriate: "(1) the debtor's investment program is connected to no legitimate business operation or to a business operation that is very small in relation to the amount of debt incurred; (2) the debtor makes highly unrealistic promises to investors; and (3) the debtor becomes grossly overextended within a short period of time.").

[141] *See supra* note 134 and accompanying text (positing that Ponzi schemes are being loosely interpreted by courts).

clear that every party implicated should be automatically denied safe harbor.[142] An ex ante rule resolves this issue because it limits courts from applying a presumption of actual fraud too loosely and affords potentially deserving parties an opportunity to seek safe harbor.

B. Using Industry Norms to Evaluate Good Faith

The second proposed rule asks courts to mirror industry norms when determining whether a party acted in good faith. This rule directs courts to evaluate only whether the counterparty asserting the defense has satisfactorily met its duties outside of bankruptcy. If it has, then the party has met its initial burden of showing good faith. If it has not, then deservedly, it loses its ability to invoke the good faith defense.[143] An important aspect of this rule is that it discourages courts from imposing additional duties on financial counterparties that do not similarly exist outside of bankruptcy.[144] This minimizes the potential for courts to unwittingly realign rights and responsibilities of financial counterparties outside of bankruptcy and promotes overall stability in the marketplace.[145]

The prime broker example discussed throughout this Note effectively illustrates the benefits derived from such a

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[142] *See supra* notes 77-79, 93-98 and accompanying text (noting the problems with a presumption of fraud).

[143] Professor Edward Morrison posits that a similar application of industry custom has already been used in the Code to police fraudulent activity: "As several courts have noted, a transaction bearing badges of fraud will rarely be one that a market participant would call customary. This is because fraud must be concealed; otherwise it attracts investigation . . . . Industry custom, then, is a benchmark for characterizing any financial transaction, even one bearing badges of fraud." Morrison & Riegel, *supra* note 13, at 659.

[144] This is similar to the rationale behind the well established *Butner* principle in bankruptcy law where absent express authority otherwise, non-bankruptcy law should be the measure of what rights are afforded to the parties. This is supposed to support the notion that bankruptcy law should not interfere with the natural state of the law unless explicitly directed to do so. *See* Butner v. United States, 440 U.S. 48 (1979).

[145] *See* discussion *supra* Part II.A.

rule. In the case of a prime broker wanting to assert a good faith defense, courts need not look any further than what the prime broker's obligations and responsibilities are outside of bankruptcy.[146] Absent any clear signs of impropriety (in which case the broker would arguably fail the first part of the test anyway), the broker has carried its initial burden of showing good faith and the analysis ends.[147] Furthermore, because courts have uniformly determined that the proper measure of good faith is *objective*, an approach that evaluates the party's actions in light of industry norms rather than judicially crafted opinions ensures a more level playing field for everyone.[148] This prevents courts from being in the problematic position of having to decide what is appropriate for market participants. This also allows parties like prime brokers to enter into contracts and transactions with confidence that they will not be held to extraordinary or unusual standards.[149]

Compare these results with the potential consequences of a different approach, such as the ad hoc method used in *Manhattan Investment Fund*, and the benefits become more apparent. There, the court found that the prime broker did not act in good faith because it failed to meet an additional diligence requirement.[150] Though the court failed to clarify what actions would suffice to meet this new duty, the court found that the broker's actions, in only taking basic steps to ferret out wrongdoing, were insufficient.[151]

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[146] *See* discussion *supra* Part II.B.

[147] *See* discussion *supra* Part III.B.

[148] *See* discussion *supra* Part II.A.

[149] *See* Morrison & Riegel, *supra* note 13, at 644 ("[Financial contracts] are protected because they are *recognized in financial markets* as financial contracts. Any judicial effort to distinguish protected and unprotected contracts based on their 'substance' is doomed to failure and can only generate significant uncertainty in the very markets the Code seeks to protect.").

[150] *See* discussion *supra* Part III.B.1.

[151] While portions of the holding were later reversed on appeal to the district court, the duty of diligence created by the court ultimately remained intact. However, while the district court did not reverse the lower court's addition of a due diligence requirement on Bear Stearns, it

The court's imposition of an additional duty on the broker—the duty to investigate—is problematic for several reasons. First, it undermines the stability that safe harbors provide by creating asymmetrical rights in and out of bankruptcy.[152] This leaves courts and parties with considerable uncertainty as to which standard should be applied in various situations. Second, by substituting its own judgment for the market's judgment, courts threaten to disrupt an efficient allocation of labor that has already proven itself immensely successful in the industry.[153] In forcing a prime broker to play a significantly different role inside bankruptcy, courts upset the prime broker's role outside bankruptcy.[154] This shift in responsibilities not only leads to tremendous inefficiencies in the market but also threatens productivity and collaboration. Third, in compelling parties to engage in acts in which they would not otherwise engage, courts create costs that are unnecessary and counterproductive.[155] Brokers who would not normally have a duty to investigate are now forced to spend extra time and money. These added expenses translate into higher fees that are eventually shifted to the investing public.

V. CONCLUSION

From the earliest versions of the Bankruptcy Code in 1978 to the most recent amendments in 2005, financial

did reverse the lower court's determination that the broker's actions were not sufficient. The determination of whether Bear Stearns acted diligently to invoke the good faith defense was ultimately remanded because it presented a genuine issue of material fact. *See In re* Manhattan Inv. Fund Ltd., No. 07-2511, slip op. at 58-59 (S.D.N.Y. Dec. 17, 2007).

152 *See* discussion *supra* Part II.A.

153 *See* discussion *supra* Parts II.B and III.B.1.

154 *See* discussion *supra* Part II.A.

155 *See* Bonded Fin. Serv., Inc. v. European American Bank, 838 F.2d 890, 893 (7th Cir. 1988) ("Exposing financial intermediaries and couriers to the risk of disgorging a 'fraudulent conveyance' in such circumstances would lead them to take precautions, the costs of which would fall on solvent customers without significantly increasing the protections of creditors.").

participants have enjoyed exclusive privileges and protections not afforded to other groups. Congress intended the safe harbors to protect the market from systemic risks by providing stability, consistency, and clarity. A system of bright line rules, though admittedly not perfect, best supports these policies because it provides courts and financial parties with clear standards by which to gauge their actions. Further, it limits the uncertainty that courts add to the interpretive process through inconsistent rulings and ad hoc determinations of fraud or intent. The first rule directs courts to evaluate Ponzi schemes on an ex ante basis to ensure that the stockbroker defense is available for deserving financial parties. The second rule directs courts to use industry custom for good faith assessments to ensure that parties are not held to extraordinary or unusual standards. Together, the rules provide courts with a practical approach that delivers sensible and reliable results in keeping with Congress's clear and original intent.