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Prime Brokers' Liability Fears

Lawsuits Brought by Collapsed Funds Have Industry on Edge

By Carol E. Curtis

As the subprime mortgage crisis continues to take a toll on hedge funds, the prime brokerage industry is casting a nervous eye toward the courts, where the outcomes of two cases involving prime broker liability in fund blowups could substantially change the way they do business with hedge funds.

The most closely watched case involves a decision handed down on Feb. 15 by the U.S. Bankruptcy Court in the Southern District of New York, ordering Bear Stearns Securities Corp. to pay nearly \$160 million it received in the form of margin payments, position closeouts and fees from Manhattan Investment Fund, because, among other things, the prime broker failed to adequately monitor the activities of the hedge fund before it collapsed in 2000 (Securities Industry News, May 28).

In that case, in January 2000, the Securities and Exchange Commission said it had concluded that the fund was in fact a Ponzi scheme. After the SEC filed a securities fraud complaint against the fund, parent Manhattan Capital Management, and founder Michael Berger, the fund filed for bankruptcy. In April 2000, Manhattan Investment Fund filed suit against Bear Stearns, seeking \$141.1 million in margin payments it had transferred to the fund's Bear Stearns account from another at Bank of Bermuda, which the fund then used to engage in securities trading.

Bear Stearns is appealing the bankruptcy court's decision, which stated that because the

firm qualified as an "initial transferee" under the bankruptcy code, it was liable to return the payments, which the court said were made into the account with the intent of defrauding the fund's creditors.

The court held that " Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong. ... Diligence required consulting easily attainable sources of information that would bear on the truth of any explanation received from the wrongdoer."

"The entire industry is watching this case," says Jacob Zamansky, an attorney and principal in New York law firm Zamansky & Associates, which represents hedge fund investors. "All of the prime brokers are concerned about their liability exposure as a result of this decision."

In a friend-of-the-court brief filed in May, the Securities Industry & Financial Markets Association (Sifma) said that if the ruling is upheld, it will "significantly disrupt current precedent, standard industry practices, and the important balance the law has struck in order to allow millions of securities and commodities transactions to be processed quickly and cheaply every day by compelling securities clearing firms and prime brokers to undertake costly, time-consuming investigations into their account holders' motives."

The Sifma brief said that the decision appears to be the first to find that deposits into a customer's account with a securities broker are

voidable under the bankruptcy code as fraudulent transfers.

"If upheld, this decision would upend long-standing industry practices and result in firms either raising costs or withholding financing," says Kevin Carroll, managing director and associate general counsel of Sifma. He asserts that if the appeals court holds against Bear Stearns, the repercussions for prime brokers could be widespread.

"The court engaged in an unprecedented interpretation of the bankruptcy code," says Carroll. "It is already firmly established that financial intermediaries like clearing firms and prime brokers cannot be held liable for merely processing transactions received from an authorized source. Sifma remains hopeful that the court will reverse its opinion in the interest of avoiding market disruption."

Another brief in support of Bear Stearns was filed jointly by the International Swaps & Derivatives Association (ISDA) and Financial Markets Lawyers Group (FMLG). If upheld, "the potentially vast negative consequences of the bankruptcy court's decision will extend far beyond the scope of this particular dispute," according to the brief, which continues, "If Bear Stearns is held liable for the fund's trading losses ... financial intermediaries could face potential liabilities that exceed their own proprietary firm capital."

The ISDA-FMLG filing also states that at least one of the legal issues--whether a financial intermediary such as Bear Stearns is subject to initial-transferee liability-- "is an important issue of bankruptcy law that has not yet been addressed in this circuit."

Despite such arguments, at least one securities industry bankruptcy expert sees a good chance that the decision will be upheld. "The broker really acts as an agent," says Stuart Gollin, a senior bankruptcy partner at New York accounting firm Weiser. "But in this case, there were transactions that were being collateralized by the margin money, and Bear Stearns had the ability to use this money to buy and sell securities."

Gollin adds that according to the bankruptcy court's decision, Bear Stearns either knew or should have known that there was fraud at the hedge fund. "In my opinion, Bear Stearns

was right in the middle of the problem," Gollin says. "They had knowledge, opportunity and control, so I think the decision will be upheld." If so, he says, "it would show that if you [as a prime broker] are holding collateral, you better find out what you are holding."

A decision on the appeal could come at any time, says an attorney familiar with the case, adding that "clearing firms want to know where they stand vis-a-vis the liability of hedge funds that fail. This case will give an indication of where" both prime brokerages and clearing firms stand.

A Second Case

On May 21, investors in Wood River Partners, a hedge fund that collapsed in 2005, filed a lawsuit in New York State Supreme Court against UBS Securities, the fund's prime broker. The suit charges that UBS not only aided fraud by Wood River, but also conceived of a plan to use inside information for its own benefit and engaged in illegal naked short sales.

The suit alleges that UBS, upon learning that Wood River principal John Whittier had secretly acquired 30 percent of Endwave Corp., a publicly held micro-cap stock in which UBS was a market maker, exploited its conflicting roles as Wood River's prime broker and custodian to "reap enormous fees and profits" by manipulating the market for the stock.

The suit claims that UBS used its Endwave holdings to establish an active short market for the stock, despite the fact that, because the Wood River stock was fully paid for and margined, the firm could not lawfully do this. The alleged naked shorting--in which borrowed securities are sold without the securities actually having been borrowed--had the effect of driving down the price of Endwave, contrary to the interests of Wood River investors. The suit says that "UBS ... was a material cause of plaintiffs' losses in excess of \$200 million," the amount the investors are claiming in damages.

Both cases highlight the potential liability of the prime broker in a hedge fund collapse, says Zamansky. "When a hedge fund goes bust, the fund becomes insolvent, and investors are looking to establish the liability of the prime broker," he says, not only because of the broker's deep pockets, but also because the

firm "may be involved in, or have knowledge of, fraudulent conduct. If the prime broker has knowledge of the fraud, they could be held liable if they do nothing to prevent it."

In Zamansky's view, "The prime broker needs to monitor and be vigilant in reporting

suspicious activity to the regulators. They may have supervisory responsibility, and can't justly claim that they are merely lenders to the hedge fund. The integrity of the financial markets depends on someone watching the hedge fund."