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IN THE

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IN RE: MANHATTAN INVESTMENT FUND, LTD., Debtor.

HELEN GREDD, CHAPTER 11 TRUSTEE
FOR MANHATTAN INVESTMENT FUND,

Plaintiff/Appellant/Cross-Appellee,

v.

BEAR, STEARNS SECURITIES CORP.,

Defendant/Appellee/Cross-Appellant.

On Appeal From The United States District Court
For The Southern District Of New York

BRIEF OF *AMICI CURIAE* SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND FUTURES INDUSTRY ASSOCIATION IN SUPPORT OF CROSS-APPELLANT BEAR, STEARNS SECURITIES CORP. AND REVERSAL OF THE DISTRICT COURT'S DECEMBER 17, 2007 DECISION

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 29(c) and 26.1(a), the Security Industry and Financial Markets Association ("SIFMA") and the Futures Industry Association ("FIA") hereby state as follows:

Amicus curiae SIFMA is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

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Pursuant to Federal Rule of Appellate Procedure 29, the Securities Industry and Financial Markets Association ("SIFMA") and the Futures Industry Association ("FIA") respectfully submit this brief as *amici curiae* in support of the cross-appeal of Bear, Stearns Securities Corp. ("Bear Stearns") from the decision of the United States District Court for the Southern District of New York (Buchwald, J.) dated December 17, 2007. The District Court erred in holding that Bear Stearns had "dominion and control" over customer deposits into a customer account such that Bear Stearns was an "initial transferee" under Section 550 of the Bankruptcy Code from whom the Trustee could "recover" those monies after the customer lost them in the course of the customer's own trading.

I. STATEMENT OF INTEREST

SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and protect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

FIA is a principal spokesman for the commodity futures and options industry in the United States. FIA's regular membership is comprised of approximately 35 of the largest United States futures commission merchants, many of whom are also broker-dealers. Among the approximately 175 firms that make up FIA's associate membership are representatives of virtually all segments of the futures industry, including both national and international exchanges, banks, law firms, accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants. FIA estimates that its members are responsible for more than 80 percent of all customer transactions executed on United States contract markets.

The District Court's decision addressed the circumstances under which a prime broker may be liable as an "initial transferee" under the bankruptcy laws for monies deposited by one of its customers into that customer's own brokerage account and subsequently lost by the customer in the course of its trading activities. SIFMA's and FIA's members routinely enter into similar transactions, and SIFMA and FIA members who are broker-dealers have a strong interest in this cross-appeal of a decision that subjects financial intermediaries like

Bear Stearns and other SIFMA and FIA members to extraordinary potential liability.[1]

II. PRELIMINARY STATEMENT

The question before this Court is whether the District Court's expansive view of "initial transferee" liability inappropriately impinges upon decades of case law holding that a brokerage firm may not be held liable for its dishonest customer's trading activities.

Michael Berger formed the Manhattan Investment Fund (the "Fund") in 1995 and served as its investment manager. Bear Stearns served as the Fund's prime broker, and the Fund maintained an account at Bear Stearns. As prime broker, Bear Stearns cleared billions of dollars of securities trades for the Fund over the course of several years. After the Fund's investment strategy (short-selling technology stocks) proved unsuccessful, Berger began misrepresenting the Fund's performance to investors and, according to the District Court, at some point Berger began operating the Fund as a Ponzi scheme. (SPA28.[2]) The District Court

[1] The issues for futures commission merchants are similar but not identical due to differences in the markets, margin, and the regulatory framework.

[2] All cites herein to the District Court's decision are to the copy included in the Special Appendix filed by the parties in this matter.

acknowledged, however, that "there is no suggestion that Bear Stearns had actual knowledge of or was a participant in Berger's fraud." (SPA22.[3])

In January 2000, the District Court, at the request of the SEC, placed the Fund into receivership, and in March 2000, the Receiver caused the Fund to file for bankruptcy. The Receiver was appointed Trustee of the Fund and thereafter commenced an adversary proceeding against Bear Stearns seeking to avoid and recover (among other things) $141.4 million in deposits made by the Fund to its account at Bear Stearns during the year prior to its bankruptcy filing (the "Deposits").[4]

The Trustee did not claim that Bear Stearns was liable for the Fund's losses as a result of some sort of failure to supervise or detect the Fund's activities as a broker-dealer, given that decades of case law reject such a responsibility.[5]

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[3] *See also Cromer Fin. Ltd. v. Berger*, 137 F. Supp. 2d 452, 472 (S.D.N.Y. 2001) (dismissing claims that Bear Stearns aided and abetted Berger's fraud).

[4] In the year leading up to its bankruptcy filing, the Fund made deposits into its account at Bear Stearns totaling $141.4 million. When the Receiver took over the Fund's affairs and at the Receiver's request, Bear Stearns wired $16.3 million, the amount that remained in the Fund's Bear Stearns account, to a different account in the Fund's name. The Bankruptcy Court held that Bear Stearns was entitled to a credit for the $16.3 million it transferred at the Receiver's request as against any liability on the Trustee's claim. As a result of that ruling, the sum in dispute on this claim was approximately $125 million.

[5] *See, e.g.*, U.C.C. § 8-503 cmt. 3 ("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

Instead, the Trustee proceeded against Bear Stearns pursuant to Sections 548(a) and 550(a) of the Bankruptcy Code. At the relevant time, Section 548(a) permitted the avoidance of "any transfer of an interest of the debtor in property" made within one year prior to the filing of a bankruptcy petition if the debtor "made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made . . .,

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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."); *Cromer*, 137 F. Supp. at 470-72 (S.D.N.Y. 2001) (dismissing Fund investors' claims that Bear Stearns aided and abetted Berger by allowing him to continue trading on Bear Stearns' credit despite allegedly knowing of his Ponzi scheme and margin violations); *Ross v. Bolton*, 639 F. Supp. 323, 327 (S.D.N.Y. 1986) (dismissing claim against clearing firm for aiding and abetting fraud where complaint did not "specify what assistance [the clearing broker] rendered other than to continue to clear transactions when it 'knew or should have known'" that accountholder was engaging in fraud), *aff'd,* 904 F.2d 819 (2d Cir. 1990); *see also Pension Comm. of Univ. of Montreal Pension Plan v. Banc of America Securities, LLC*, 446 F. Supp. 2d 163, 202-03 (S.D.N.Y. 2006) (prime broker owed plaintiff hedge fund investors no duty "to monitor, verify, or investigate the veracity of the information disseminated by" hedge fund manager); *Lesavoy v. Lane*, 304 F. Supp. 2d 520, 525, 526 (S.D.N.Y. 2004) (clearing firms owed no duty to accountholders' beneficiaries, as a broker "'has no duty to monitor a nondiscretionary account'" (quoting *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002)), *aff'd in part and rev'd in part on other grounds*, 170 Fed. Appx. 721 (2d Cir. 2006); *Stander v. Fin. Clearing & Servs. Corp.*, 730 F. Supp. 1282, 1286 (S.D.N.Y. 1990) ("It is clear that the simple providing of normal clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker.").

indebted." 11 U.S.C. § 548(a)(1)(A).[6] Because the District Court found that the Fund was a Ponzi scheme and that the Deposits were "in furtherance" of that scheme, (SPA28), it applied the "Ponzi scheme presumption" and concluded that the Fund made the Deposits with the actual intent to defraud its creditors. (*Id.*) As a result, the Trustee could avoid the Deposits on that basis and "recover" them from Bear Stearns if it could show that Bear Stearns was an "initial transferee" of the Deposits under Section 550(a) of the Bankruptcy Code (subject to Bear Stearns' later ability to prove a "good faith" affirmative defense). (SPA29.)

On the question of whether Bear Stearns could be an "initial transferee" of the Deposits, it is undisputed that Bear Stearns properly treated the Deposits as customer funds under the SEC's Customer Protection Rule (Rule 15c3-3, 17 C.F.R. 240.15c3-3a), which required Bear Stearns to place the Deposits into a Special Reserve Account for the Exclusive Benefit of Customers and which prohibits Bear Stearns from using such customer funds for any purpose other than customer transactions. It is undisputed that, although the Fund subsequently lost most of the Deposits as a result of its unsuccessful trading in the securities markets, the Fund did not lose any of that money to Bear Stearns. Rather, the Fund lost

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[6] Section 548 was amended in 2005. Among other things, it now provides for a two-year avoidance period. *See* P.L. 109-8, § 1401(1), (2). A copy of the statute as in effect prior to the 2005 amendments is included in the parties' Special Appendix at SPA117-118.

money to its counterparties in the market in the various securities transactions it undertook (transactions that Bear Stearns merely facilitated on a non-discretionary basis). It also is undisputed that the Deposits were ***not*** made to repay any debt owed to Bear Stearns. And it is undisputed that the Fund paid Bear Stearns less than $2.5 million for its services over three and a half years—a tiny fraction of the amount the Trustee sought to "recover."

Notwithstanding these undisputed facts, the District Court relied on certain industry-standard provisions in the Professional Account Agreement (the "Agreement") between the parties to conclude that Bear Stearns had "dominion and control" over the Deposits sufficient to make Bear Stearns an "initial transferee" from whom the Deposits could be recovered under Section 550(a) of the Bankruptcy Code. In other words, the District Court found that the Trustee (and by extension the Fund's investors and creditors) could recover from Bear Stearns monies lost by the Fund (***not*** Bear Stearns) to third parties (***not*** Bear Stearns) because Bear Stearns had certain limited, legally circumscribed and contractually defined rights with respect to the Fund's money as it passed through the Fund's account in the course of the Fund's trading. Because of this decision, the only way Bear Stearns could avoid ultimate liability was to carry the burden at trial and establish to the satisfaction of a jury that it acted in good faith.

Under the District Court's decision, if a fraudster deposits money in an account at a brokerage firm subject to such standard industry terms, loses the money in the markets, and then declares bankruptcy, the fraudster's estate can "recover" the money from the broker unless the broker ultimately can prove its good faith (an endeavor that often, as it did in this case, will require a time-consuming and expensive trial). The District Court's decision thus places the interests of the fraudster's creditors and investors over the interests of the brokerage firm, its other customers, its investors and its creditors. That result is particularly unfair especially where, as here, the fraudster lost its investors' money through its own actions, not those of the brokerage firm, and the amount of money subject to "recovery" dwarfs the amount earned by the brokerage firm as a result of its customer relationship with the fraudster.

As a matter of national public policy, the District Court's decision should be reversed because it sharply undercuts the overarching investor protection objectives of Congress and the SEC. Specifically, the decision extrapolates "dominion and control" based on account structures and terms that are an outgrowth of the SEC's detailed rules governing customer funds, margin and capital, and improperly exposes the innocent shareholders of Bear Stearns (which would include retirees and pension funds) to risk created by the fraudulent conduct of an unrelated third party. In addition, the decision inappropriately would diminish the pool of potential capital available to ***all*** customers of a broker-dealer for the benefit of a ***single*** bankrupt customer.

The District Court's decision, if upheld, also would significantly disrupt industry practice by requiring securities clearing firms and prime brokers to undertake time-consuming and costly investigations into their customers' financial stability, their investment activity and their financial reporting. Such obligations do not exist under the current regulatory scheme applicable to the securities markets. Indeed, since the Seventh Circuit established the "dominion and control" test twenty years ago, such obligations have not been imposed under the bankruptcy laws.[7] If firms are required to shoulder these heightened obligations, it necessarily would result in reduced market liquidity, increased costs to customers, and potentially fewer prime brokerage service providers as some will inevitably exit the business given its extremely tight margins and limited profitability. This outcome also would generally disserve investors.

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[7] The District Court's erroneous ruling on the "initial transferee" issue also has the potential to create uncertainty in the courts. One court outside this Circuit recently followed the course charted by the District Court. In *Derivium Capital, LLC v. Wachovia Sec., LLC*, __ B.R. __, 2008 WL 4775918 (Bankr. D.S.C. Sept. 19, 2008), the bankruptcy court denied Wachovia's motion to dismiss. Citing the District Court's decision in this case, the court found that plaintiff might be able to show that Wachovia had "dominion and control" over the debtor's "margin account" pursuant to the parties' brokerage agreement. *See id.* at *7.

Because the District Court erred in finding that Bear Stearns had "dominion and control" over the Fund's Deposits, and because the District Court's decision undermines the federal investor protection scheme, *amici* SIFMA and FIA support Bear Stearns in its request that this Court reverse the District Court's decision at summary judgment and find that Bear Stearns was not an initial transferee of the Fund's Deposits under Section 550(a) of the Bankruptcy Code.

III. ARGUMENT

A. The Dominion And Control Test

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

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

11 U.S.C. § 550(a).

The Bankruptcy Code does not define the term "initial transferee," but, considering the statutory language and the purposes of fraudulent transfer law, all of the Circuit Courts of Appeal to consider the issue, including this one, have concluded it means "something more particular than the initial recipient" of the transferred property. *Christy v. Alexander & Alexander of New York, Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52, 57 (2d Cir. 1997).

To determine whether a party acts as "something more" than an initial recipient or "mere conduit," the test, first enunciated by the Seventh Circuit and later adopted by this Circuit, is whether, ***at a minimum***, the recipient has "dominion over the money or other asset, the right to put the money to one's own purposes." *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 893 (7th Cir. 1988); *see also, e.g., Finley*, 130 F.3d at 57 (following the "widely adopted" logic of *Bonded*); *Tese-Milner v. Brune (In re Red Dot Scenic, Inc.)*, 293 B.R. 116, 119 (S.D.N.Y.) (following the "dominion and control" test articulated in *Bonded*), *aff'd,* 351 F.3d 57 (2d Cir. 2003); *Tese-Milner v. Moon (In re Moon)*, 385 B.R. 541, 552 (Bankr. S.D.N.Y. 2008) ("If an entity is not permitted—by law, contractual obligation or otherwise—to expend the assets as it desires, it is not an 'initial transferee,' but rather a 'mere conduit' that cannot be held liable under section 550."); *Geltzer v. D'Antona (In re Cassandra Group)*, 312 B.R. 491, 496 (Bankr. S.D.N.Y. 2004) ("In order to incur liability as an initial transferee, a party must have exercised dominion and control over the property transferred."); *Sec. Inv. Prot. Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 313 (Bankr. S.D.N.Y.

1999) ("[A]n initial transferee is the person who has dominion and control over the subject of the initial transfer to the extent that he or she may dispose of it as he or she pleases . . . .").[8]

As these cases suggest, dominion and control indicates a "high degree of freedom" over the transferred funds—the legal right to do as one pleases, even if that means putting the money "in lottery tickets or uranium stocks." *Perrino v. Salem, Inc.*, 243 B.R. 550, 561 (D. Maine 1999) (*quoting Bonded*, 838 F.2d at 893). Here, Bear Stearns had no legal right to use the Fund's Deposits as it pleased. Accordingly, the District Court erred in finding that Bear Stearns was an "initial transferee" of the Deposits that could be liable for their "return."

B. Because The Deposits Remained The Property Of The Fund, Bear Stearns Lacked Dominion And Control Over Them

The District Court itself found that "at all times Bear Stearns acted in accordance with . . . SEC Rule 15c3-3," which "precluded Bear Stearns from using any monies in the account for purposes unrelated to the Fund's trading." (SPA21-

[8] The District Court appeared to determine that Bear Stearns could not be a "mere conduit" because it did not serve as a middle-man between the Fund and some third party to whom the Fund transferred money. (SPA31-32.) The lack of a traditional third party in this particular scenario, however, does not preclude the possibility that Bear Stearns acted as a "conduit" when the Fund transferred monies from its own account at the Bank of Bermuda to its own account at Bear Stearns. In other words, Bear Stearns was a "mere conduit" as the Fund moved its own money from one pocket to another pocket.

22.) This finding alone should have sufficed to establish that Bear Stearns did ***not*** have dominion and control over the Deposits.

Rule 15c3-3, referred to as the Customer Protection Rule, dates back to 1972. It was designed, among other things, to "prevent broker-dealers from using funds or securities held on behalf of customers to finance proprietary and other non-customer transactions." *Upton v. SEC*, 75 F.3d 92, 93 (2d Cir. 1996); *see also Ferris, Baker Watts Inc. v. Stephenson (In re MJK Clearing, Inc.),* 286 B.R. 109, 130 (Bankr. D. Minn. 2002) ("The amount of funds to be deposited in the Reserve Account is computed on a weekly basis pursuant to [the] Formula For Determination for Reserve Requirements for Brokers and Dealers. The Reserve Formula is designed to eliminate the use of customers' funds and securities by broker-dealers in financing firm overhead and such dealer activities as market making, proprietary trading, and underwriting.") (citation omitted); Statement of SEC Div. of Trading & Markets Regarding the Protection of Customer Assets (Sept. 20, 2008), *available at* http://www.sec.gov/news/press/2008/2008-216.htm ("Customers of U.S. registered broker-dealers benefit from the extensive protections provided by the Commission rules, including the Customer Protection Rule, as well as protection by the Securities Investor Protection Corporation (SIPC). The Commission's Customer Protection Rule requires a broker-dealer to segregate customer cash and securities from a broker-dealer's own proprietary assets."). One reason for this segregation of customer funds is "[t]o facilitate the liquidations of insolvent broker-dealers and to protect customer assets in the event of a SIPC liquidation through a clear delineation in Rule 15c3-3 of specifically identifiable property of customers." Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 34-9856, 1972 WL 125352 (Nov. 17, 1972); *see also MJK Clearing*, 286 B.R. at 130 ("The purpose of the Customer Protection Rule is also to ensure that customer property in a failed brokerage firm is available to satisfy the claims of customers . . . ."). In other words, in the event of a brokerage firm's failure, customers are entitled to the return of ***their property***.[9]

Under this customer protection framework, therefore, the Fund's Deposits to its own brokerage account remained the property of the Fund, and Bear Stearns plainly lacked the legal right to use the Deposits for its own purposes. As such, Bear Stearns also lacked dominion and control over them and cannot be deemed to be an "initial transferee" under the law of this (or any other) Circuit. This Court should not condone an expansive interpretation of bankruptcy law that

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[9] State law generally is to the same effect. *See, e.g.,* U.C.C. § 8-503 cmt.1 ("[S]ecurities that a firm holds for its customers are not general assets of the firm subject to the claims of creditors."). Broker-dealers that do use customer funds for their own purposes can be held liable for conversion. *See, e.g., Schruefer v. Winthorpe Grant, Inc.*, No. 99 Civ. 9365, 2003 WL 1108933, at *5-6 (S.D.N.Y. Mar. 12, 2003) (granting plaintiff judgment on conversion claim where defendant broker-dealer and its personnel, instead of investing money as instructed, withdrew and redirected funds from plaintiff's account for defendants' use).

will alter the respective positions of the parties in an area that is comprehensively covered by the securities laws.

C. A Mere Conduit Or Recipient Does Not Become An "Initial Transferee" Merely Because He Or She Derives Some Benefit From A Transfer

Notwithstanding its recognition that Bear Stearns treated the Fund's Deposits appropriately under the Customer Protection Rule, the District Court found that certain industry-standard provisions of the Agreement—which are an outgrowth of that SEC-mandated structure—gave Bear Stearns "dominion and control" over the Fund's Deposits by virtue of providing Bear Stearns with some incidental, contingent benefits in the event the Fund failed to meet its own obligations. This is not the law. As discussed below, courts consistently have found that even an entitlement to some direct benefit from the transfer in dispute—such as a commission or the payment of fees—does not render a party otherwise a conduit or mere recipient an initial transferee as to the entirety of the property in dispute. And if such direct benefits will not render a recipient an initial transferee, the fact that the Fund, by contract, granted Bear Stearns the ability to take certain actions with respect to the Fund's account to meet ***the Fund's obligations***, even if those actions incidentally could have benefited Bear Stearns under certain circumstances, also logically should not render Bear Stearns an initial transferee.

In particular, in support of its finding that "dominion and control" over the Deposits lay with Bear Stearns, the District Court cited four provisions of the Agreement between the Fund and Bear Stearns that gave Bear Stearns: (1) a security interest in the money in the Fund's account; (2) the ability to set the maintenance margin requirement for the account (that is, the percentage of the value of its open short positions that the Fund was required to maintain in the account); (3) the ability to prevent the Fund from withdrawing money from the account while it had open short positions; and (4) the ability to use the money in the Fund's account to liquidate the Fund's open short positions. (SPA21; SPA33.)

The District Court characterized these features as permitting Bear Stearns to act for its own purposes, thus giving it "dominion and control" over the Deposits. (SPA35.) In so finding, however, the District Court overanalyzed the holding of *Bonded*, and improperly divorced Bear Stearns' rights under the Agreement from the overarching purpose of the Agreement—namely, to facilitate ***the Fund's*** trading activities. *Cf. Nordberg v. Societe Generale (In re Chase & Sanborn Corp.)*, 848 F.2d 1196, 1199 (11th Cir. 1988) (cautioning "courts to step back and evaluate a transaction in its entirety to make sure that their conclusions are logical and equitable"). As the SEC itself argued in an *amicus* brief filed in a similar fraudulent conveyance action, the sort of incidental security and other rights cited by the District Court here as conferring dominion and control over the

Deposits on Bear Stearns differ little from similar rights that exist in a variety of commercial settings. (*Amicus* Br. of the Securities & Exchange Comm'n, filed in *Kaiser Steel Res., Inc. v. Charles Schwab & Co.*, No. 90-1078 (10th Cir.), at 23.[10]) Yet those commonplace rights never have been viewed by the courts to confer dominion and control on a party. (*Id.* at 24.)

To the contrary, courts considering commercial relationships in which a recipient was permitted to use funds solely for purposes approved by the debtor repeatedly have found the recipient ***not*** to be an initial transferee—***even when some of those purposes directly benefited the recipient***. *See, e.g., Andreini & Co. v. Pony Express Delivery Servs., Courier Express, Inc. (In re Pony Express Delivery Servs., Inc.)*, 440 F.3d 1296, 1303 (11th Cir. 2006) (finding that insurance broker was not "initial transferee" of client funds where, among other things, "[a]t no time were the transferred funds under the [broker's] unrestricted legal control," although broker had paid premium on client's behalf prior to receipt of funds); *Sec. First Nat'l Bank v. Brunson (In re Coutee)*, 984 F.2d 138, 141 (5th Cir. 1993) (finding that law firm was not initial transferee with respect to funds received on behalf of client: "The firm's role with respect to the received money was to accept the funds in settlement of its client's case, deposit the money in trust, keep as fees

[10] A copy of this brief is included in the Appendix filed by the parties at A1148-1191.

only what the Coutees agreed to, and pay the rest to the bank on behalf of the Coutees in satisfaction of their loan."); *Moon*, 385 B.R. at 553 ("[T]he Court rejects the contention that Mr. Paul was an 'initial transferee' as to the entirety of the Settlement Proceeds—based on the fact that the full amount of the Settlement Proceeds initially went into his attorney trust account, or otherwise," although Paul deducted his fees and expenses from Settlement Proceeds before paying remainder to client); *see also Finley*, 130 F.3d at 59 (holding "that a commercial entity that, in the ordinary course of its business, acts as a mere conduit for funds and ***performs that role consistent with its contractual undertaking*** in respect of the challenged transaction, is ***not*** an initial transferee within the meaning of § 550(a)(1)") (emphasis added).

Another district court considering much the same theory as that put forth by the Trustee here wisely rejected it. *See Kaiser Steel Res., Inc. v. Jacobs (In re Kaiser Steel Corp.)*, 110 B.R. 514 (D. Colo.), *aff'd on other grounds sub nom., Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990). In *Kaiser*, the company sought to recover amounts paid to Charles Schwab, which had redeemed its customers' stock in Kaiser following Kaiser's merger into another company. *See id.* at 517. Although, like the Agreement here, "Schwab's form agreements with its customers provide[d] that all securities and money held in Schwab accounts [were] subject to a lien for the discharge of customer indebtedness to Schwab," and although some of Schwab's account agreements "permit[ted] Schwab to pledge securities in Schwab's possession to secure amounts due from customers," the district court found that Schwab was not the "initial transferee" in the stock redemption transactions. *Id.* Rather, the district court concluded that, despite the security provisions in its customer agreements and even despite Schwab's rights to vote its customers' stock in some circumstances, there was ***"no evidence that Schwab could arbitrarily apply customer funds for its own benefit."*** *Id.* at 521 (emphasis added); *see also, e.g., Poonja v. Charles Schwab & Co. (In re Dominion Corp.)*, 199 B.R. 410, 414-15 (9th Cir. 1996) (finding that Schwab was not initial transferee of funds deposited to securities account, although account agreement granted Schwab "a lien on funds and securities in the account to secure its payment for charges").[11]

To the extent that the District Court relied on decisions from the Fourth and Ninth Circuits to find that a recipient may be an initial transferee even without "unfettered control" over the funds in dispute (SPA32), neither case is controlling precedent in this Circuit. More importantly, both are plainly

[11] The SEC itself advocated for this outcome in *Kaiser*. (*Amicus* Br. of the Securities & Exchange Comm'n, filed in *Kaiser Steel Res., Inc. v. Charles Schwab & Co.*, No. 90-1078 (10th Cir.), at 23.)

distinguishable on their facts and do not support the conclusion reached by the District Court here.

In *Lowry*, the debtor paid $73,000 to one of its creditors, Logan; Logan deposited the $73,000 into its bank account; pursuant to a standing order issued by Logan to the bank, the bank then transferred the $73,000 to one of Logan's creditors, Security Pacific. *Lowry v. Sec. Pac. Bus. Credit, Inc. (In re Columbia Data Prods., Inc.)*, 892 F.2d 26, 27 (4th Cir. 1989). The trustee in bankruptcy sought to recover the $73,000 from Security Pacific as the "initial transferee," arguing that because Logan was required, by virtue of its agreement with Security Pacific, to pay over the $73,000 received from the debtor, Logan lacked "dominion and control" over the monies. *Id.* at 29. The so-called restrictions on the recipient's use of the funds in dispute arose not from an agreement between the debtor and the recipient (Logan), however, but from an agreement between the recipient and a third party with whom the recipient did business (Security Pacific). The recipient (Logan) undoubtedly put the funds to its own use—even if that use had been determined prior to its receipt of the funds—and the Fourth Circuit properly rejected the trustee's position. *See id.* ("Logan used the funds for its own purpose—to reduce its debt to Security Pacific."). Under these circumstances, Logan was the initial transferee, not the bank or Security Pacific. *Lowry* bears little on this case, where Bear Stearns' limited rights with respect to the Fund's Deposits into its account were a matter of contract between Bear Stearns and the Fund. Bear Stearns did not use the Deposits for its own purposes to satisfy a pre-existing debt or obligation it had elsewhere.

Incomnet also bears no meaningful resemblance to this case. *See Univ. Serv. Admin. Co. v. Post-Confirmation Comm. of Unsec. Creditors of Incomnet Commc'ns Corp. (In re Incomnet, Inc.)*, 463 F.3d 1064 (9th Cir. 2006). That case involved contributions by a telecommunications carrier to the Universal Service Administrative Company ("USAC"), a non-profit corporation designated by the FCC to collect, pool and disburse carrier contributions to the Universal Support Fund ("USF"). *See id.* at 1067. When Incomnet's creditors sought to recover its contributions to USAC, USAC invoked various restrictions imposed under the statutory and regulatory scheme in which it operated to argue that it lacked dominion over the funds. *See id.* at 1072. However, any restrictions on USAC's use of the funds were not imposed by the debtor, Incomnet; rather, those restrictions were imposed by statute. *See id.* at 1075 ("USAC received the funds from Incomnet without any restrictions *from Incomnet* on their use.").

Here, in contrast, Bear Stearns had no ability to put the Deposits to any use but those agreed to by the Fund in order to facilitate the Fund's trading. That some of those permitted uses also had the potential to benefit Bear Stearns by reducing the chances that Bear Stearns would be required to access its own capital if the Fund could not meet the Fund's obligations does not mean that Bear Stearns had the type of access that is a prerequisite to "dominion and control" over the Funds' Deposits.

The District Court concluded that it is not necessary for a recipient of money to have "unfettered control" to have "dominion and control" and be deemed an "initial transferee." (SPA32-33, citing *Lowry* and *Incomnet.*) Close analysis of the cases reveals, however, that the dispositive question is not whether the recipient's level of control was limited; rather, the dispositive question is how it came to be that the recipient's control was limited. The cases cited by the parties on this question can be segregated into two groups: First are the cases where the recipient owes a pre-existing debt or obligation to a third party and then uses the money to satisfy that debt or obligation. In these cases, the courts have held that the recipient is an initial transferee because it had sufficient dominion and control over the money to use it for its own purposes, and did so. *Lowry* and *Incomnet* are examples of this type of case. In the second group, the recipient of the money is a financial institution that holds the money in an account for the benefit of its customer. In these cases, the recipient does not have a pre-existing debt or obligation to a third party, but, instead, has certain inchoate contractual rights that allow the recipient financial institution to protect itself under certain circumstances that are out of its control. *Kaiser* and *Poonja* are examples of this type of case. In these cases, the courts have held that the recipient financial institution is not an initial transferee because any rights it has to the money are prospective and conditional. Bear Stearns is in this second group and, as such, is not an initial transferee under the bankruptcy laws.

The conditional, prospective protections embodied in the Agreement were designed to protect Bear Stearns in the event that its customer did not live up to its own obligations. For example, Bear Stearns was entitled to restrict the Fund from withdrawing money from the account if the Fund had outstanding short positions in the market. The Fund's remedy in that situation would have been for it to cover its short positions, whereupon the money would have been released. The only thing that would have prevented the Fund from accessing its own money would have been its own actions (*i.e.*, holding open short positions), actions that were curable by the Fund itself.

Finally, although the District Court suggested otherwise, it should be noted that there is no simple solution to the problem posed by its decision to find Bear Stearns an "initial transferee" who could be required to "return" the Fund's Deposits—notwithstanding that they exceeded by more than $120 million the consideration paid to Bear Stearns for the services it provided to the Fund. As the District Court noted in an earlier decision in this matter, margin and other regulatory requirements for short sellers are

> designed to protect brokerage houses by guaranteeing that their loans to short sellers are repaid. This protection, in turn, permits brokerage houses to serve an important function for our securities markets by 'standing behind' trades. Well-capitalized brokers such as Bear, Stearns provide the often large amounts of cash and securities needed to complete securities transactions, thus permitting the securities market to function efficiently.

Bear Stearns Sec. Corp. v. Gredd, 275 B.R. 190, 198 (S.D.N.Y. 2002). Even to the extent the federal securities laws and regulations would permit the modification of certain terms in broker-customer agreements, prime brokers and others cannot simply "redraft" their account agreements to avoid the threat of disproportionate liability created by the District Court's holding without fundamentally altering the manner in which the securities markets function. *See id.* ("If we were to accept the Trustee's arguments presented here, it would be riskier for brokers to stand behind customer trades and their protective reactive actions would, no doubt, impair the efficiency of our securities markets."). This could lead to further impediments to an orderly marketplace and prompt additional, unwanted, gyrations in the financial markets.

The District Court's holding that Bear Stearns was an initial transferee that could be held liable for the "return" of the Fund's Deposits runs contrary to well-established bankruptcy law. It also threatens to disrupt long-standing practices intended to facilitate the efficient operation of the securities markets. It should be reversed.

IV. CONCLUSION

If not reversed, the District Court's unprecedented interpretation of the Bankruptcy Code would disrupt the economic efficiencies and standard industry practices that currently prevail and that support and promote the overarching federal investor protection scheme. *Amici* respectfully request that this Court reverse the decision of the District Court holding that Bear Stearns was an "initial transferee" of the Fund's Deposits under Section 550(a) of the Bankruptcy Code.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

The foregoing brief complies with the type-volume limitation set forth in Federal Rule of Appellate Procedure 29(d), dated September 24, 2008, which permits an *amicus curiae* to file a brief of no more than 7,000 words. According to the word count feature on Microsoft Word, this brief, including text, footnotes, headings and quotations (but excluding the parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii)), contains 6,168 words. The foregoing brief further complies with the typeface requirements of Fed. R. App. P. 32(a)(7)(C) and the typeface style requirements of Fed. R. App. P. 32(a)(6) because the brief has been prepared in proportionately spaced typeface using Microsoft Word in 14-point font and Times New Roman.

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