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Securities Clearing Firms: Beware Fraudulent Transfers

Law360, New York (August 03, 2012, 1:08 PM ET) -- On July 3, 2012, the United States Court of Appeals for the Second Circuit refused to vacate an arbitration award against Goldman Sachs Execution & Clearing LP. The court left intact the arbitration panel's finding that the clearing firm was liable as the "initial transferee" of a fraudulent transfer by a customer engaged in a Ponzi scheme.

The Second Circuit's decision weakens the "mere conduit" defense that has traditionally shielded clearing firms from fraudulent transfer claims, and may increase the risk associated with accepting deposits from dishonest or insolvent customers. Goldman Sachs Execution & Clearing LP v. Official Unsecured Creditors' Comm. of Bayou Group LLC, No. 10-5049-cv, 2012 U.S. App. LEXIS 13531 (2d Cir. July 3, 2012).

Background

In 1999, Goldman began acting as the sole clearing broker and prime broker for a group of hedge funds affiliated with Bayou Fund LLC. As is standard in the brokerage industry, Bayou's account at Goldman was governed by a customer agreement requiring it to resolve any disputes with Goldman through arbitration rather than a court proceeding.

In 2005, the Bayou funds collapsed as it became clear they had been engaged in a massive Ponzi scheme. In this respect, the Bayou funds were an important precursor to the better-known Ponzi schemes run by Bernard L. Madoff and Allen Stanford.[1]

Bayou later filed for bankruptcy protection, and the bankruptcy court authorized the official unsecured creditors' committee to prosecute any claims the debtors' estates might have against Goldman.

In keeping with the arbitration clause of the customer agreement, the committee brought a fraudulent transfer claim against Goldman in an arbitration proceeding before the Financial Industry Regulatory Authority.

In the FINRA proceeding, the committee alleged that transfers totaling approximately $20.6 million between Bayou's and the other funds' accounts at Goldman constituted "fraudulent transfers" under sections 544 and 548 of the Bankruptcy Code.

The committee further maintained that Goldman was liable for these transfers as an "initial transferee" under section 550(a) of the Bankruptcy Code, which provides that a bankruptcy trustee, or a creditors' committee acting in the place of a bankruptcy trustee, may recover fraudulently transferred property from "the initial transferee of such transfer."

Goldman raised a standard defense to section 550(a), arguing that it had not been an "initial transferee" but rather had acted as a "mere conduit" for Bayou's funds.

Generally speaking, a recipient of fraudulently transferred property qualifies as an "initial transferee" only if the recipient exercises "dominion and control" over the fraudulently transferred property. Courts have traditionally considered a recipient that is not entitled to make use of the funds for its own purposes to be a "mere conduit" not subject to liability under section 550(a).

The FINRA arbitration panel rejected Goldman's "mere conduit" defense and granted a $20,580,514.52 award in favor of the creditors' committee. Arbitrators do not generally issue written opinions, so there is no express written analysis detailing on what case law the arbitration panel relied in reaching its conclusion that Goldman was liable as an initial transferee.

Goldman filed a petition with the District Court for the Southern District of New York, seeking to have the arbitration award vacated. The Federal Arbitration Act allows a U.S. district court to vacate an arbitration award, but only under four narrow sets of circumstances, one of these being "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made." 9 U.S.C. § 10(a)(4).

Some courts, including the Second Circuit, have construed this provision of the Federal Arbitration Act as authorizing courts to vacate awards in cases where the arbitrator has "manifestly disregarded the law."

Accordingly, in its petition to the district court, Goldman argued that the arbitration panel had "manifestly disregarded the law" by failing to recognize its "mere conduit" defense. The district court refused to vacate the arbitration award, and Goldman appealed to the Second Circuit.

Analysis

The Second Circuit noted at the outset of its decision that the standard for appellate review of arbitration awards is highly deferential. Specifically, in order to overturn an arbitration award on the grounds that the arbitrator "manifestly disregarded the law," an appellate court must find that the arbitrator knowingly ignored a governing legal principle that was "defined, explicit and clearly applicable."

The Second Circuit affirmed the Southern District's finding that the "mere conduit" defense was not clearly applicable in Goldman's case, and that the FINRA arbitration panel therefore did not "manifestly disregard" this defense in ruling against Goldman.

The Second Circuit based its conclusion that the arbitration panel had not "manifestly disregarded the law" on a 2007 New York Southern District Court opinion that also dealt with the mere conduit defense.

In Bear Stearns Securities Corp. v. Gredd (In re Manhattan Inv. Fund, Ltd.), 397 B.R. 1 (S.D.N.Y. 2007), the Southern District held that Bear Stearns was liable as the "initial transferee" of funds that a Ponzi scheme customer had transferred into its margin account at the brokerage. The court concluded that Bear Stearns had dominion and control over the customer funds because the governing customer agreement gave Bear Stearns the right to use the funds to protect itself from the risk associated with stock loans it made to the customer.

In addition to giving Bear Stearns a security interest in the customer account, the relevant customer agreement gave Bear Stearns the right to:

1. Set any level of maintenance margin for the account;
2. Prevent the customer from withdrawing money from its account while there were open short positions supported by the account; and
3. Use the funds in the account to liquidate the customer's open short positions, with or without the customer's consent.

In holding that these customer agreement provisions were sufficient to establish "dominion and control," and thus transferee liability, Gredd deviated from a long line of cases holding that financial institutions do not exercise sufficient "dominion and control" over funds held in customer accounts to qualify as "initial transferees."

The Second Circuit found that the facts in Gredd bore "striking similarities" to the facts in the instant case insofar as both cases involved a hedge fund engaged in a Ponzi scheme that deposited funds at a brokerage pursuant to a customer agreement that gave the brokerage "broad discretion" over the use of the funds.

In the Second Circuit's view, the terms of the industry-standard customer agreement at issue in Gredd were "similar, if not identical" to the terms in Goldman's agreement with Bayou.

Specifically, under the Goldman agreement, Goldman received a security interest in the deposited funds, and it also had the right:

1. To require the Bayou hedge funds to deposit cash or collateral with Goldman to assure due performance of open contractual commitments;
2. To require the hedge funds to maintain such positions and margins as Goldman deemed necessary or advisable;
3. To lend either to itself or to others any of the hedge funds' securities held by Goldman in a margin account; and
4. To liquidate securities and/or other property in the hedge funds' accounts without notice to ensure that minimum maintenance requirements were satisfied.

Goldman, 2012 U.S. App. LEXIS 13531, at *8.

Although the Second Circuit relied on Gredd, it fell short of actually endorsing Gredd's holding, instead stating: "While we have not previously endorsed the district court's decision in Gredd — and do not do so here — neither have we rejected it."

Accordingly, the Second Circuit held that the FINRA arbitration panel had not "manifestly disregarded the law" in rejecting Goldman's defense, as the arbitration panel could reasonably have found Goldman to be an "initial transferee" under the legal principles articulated in Gredd.

Conclusion

Although Goldman was decided under a highly deferential standard for appellate review of an arbitration award, the case could impact the real or perceived risk that clearing firms face with respect to liability for fraudulent transfers. Arbitration awards technically have no binding precedential value, but arbitrators nonetheless often look to earlier arbitration awards for guidance in deciding new cases.

The Second Circuit’s affirmance of the arbitration award in Goldman thus makes it more likely that arbitrators will recognize fraudulent transfer claims against clearing brokers in the future.

Additionally, the Goldman decision, while not a complete endorsement by the Second Circuit of the Gredd opinion, lends heft to that controversial district court decision, making it more likely other courts will reach similar rulings.

The increased risk of liability that clearing brokers face as a result may lead to increased compliance costs, as clearing firms may need to implement new procedures to confirm the legitimacy and solvency of their customer accountholders.

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