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HEDGE-FUND FRAUD: RECENT CASES AND THE PRIME BROKER’S GOOD FAITH DEFENSE

JORDAN WEBER*

The Southern District of New York’s recent bankruptcy court rulings have baffled the prime brokerage industry. Past legislation intended to insulate prime brokers from risks associated with hedge funds through the good faith defense; however, recent rulings have threatened to put prime brokers on the hook for fraudulent hedge-fund losses. Juries who decide whether prime brokers have acted in good faith may upset the original risk distribution among brokers, investors, and hedge-fund managers. The good faith defense should be available to prime brokers like Bear Stearns who, after following normal industry practices, fail to detect fraud immediately or at all.

1. INTRODUCTION

Bernard Madoff, a trusted member of the Wall Street asset management community, was recently found to have defrauded investors of an estimated $50 billion. The fraud dwarfs any Ponzi scheme in recorded history and has once again called attention to what some see as a renegade industry. While the Madoff scandal may not significantly impact the legal situation faced by prime brokers, it is a stark reminder of the evolving risk profile facing prime

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1 Carrie Coolidge, Lessons For Madoff Investors From The Bayou Fund Ponzi Scheme, FORBES (Dec. 12, 2008).
brokers who could be forced to return margin payments from fraudulent fund managers.²

A recent court decision ordering Bear Stearns to pay nearly $160 million for accepting payments from the fraudulent hedge fund Manhattan Investment Fund (MIF) threatened broad, detrimental implications for the financial services industry until it was overturned on appeal roughly a year later. One senior partner at the law firm Greenberg Traurig in New York was reported to say, “This decision does not just affect prime brokers, but any firm that extends credit to hedge funds. Essentially the judge is saying that anyone extending credit to a hedge fund is a guarantor against fraud committed by that hedge fund.”³

Prime brokers brought in over $10 billion of revenue from prime-brokerage services in 2007.⁴ With so much at stake, prime brokers are reassessing risk profiles on their dealings with hedge funds. If prime brokers unknowingly accept payments from fraudulent hedge-funds without doing the appropriate due diligence, they could be forced to return large sums of cash that would otherwise be used to cover positions made by the hedge-fund. The law protects brokers who unknowingly accept such payments with the “good faith defense.” However, even in light of the recent jury ruling in favor of Bear Stearns, it remains unclear what constitutes a good-faith effort to avoid fraudulent transfers. Requiring prime brokers to investigate high-risk hedge funds is incongruent with the intent of policymakers who created safe-harbor provisions to protect clearing firms. The law ought to first look to outside requirements and normal industry practices to determine if a prime broker accepted a transfer

² “Prime Brokers” are, loosely defined, entities that execute and clear trades for hedge funds. A “margin payment” is the transfer of funds from a fund to a broker for the purpose of posting collateral for borrowed assets.

³ Helen Avery, Litigation: ISDA and Fed Back Bear Stearns, EUROMONEY, June 2007, at 44.

in good faith. Under this bright line, bankruptcy law would operate in agreement with common law governing fraudulent transfers and with current policy that places the risk of hedge-fund failure on the investors.

II. BACKGROUND

Since the turn of the millennium, hedge funds have been the latest Wall Street craze; they represent everything that is exotic about the growing complexity of financial markets. From 1999 to 2004, assets managed by hedge funds increased by 260%. Funded by "accredited" investors and not subject to the same regulations that other funds must follow (e.g. mutual funds), hedge funds often use highly leveraged (and, therefore, risky) strategies to produce greater returns. These greater returns not only make hedge funds attractive, but the mystery in which hedge funds operate also piques the public's interest. Most of the mystery stems from the complexity of the financial transactions in which hedge funds traditionally participate. Hedge funds have experienced staggering growth in the past decade, both in numbers and in assets managed.

As one might expect, the beginning of the hedge-fund boom also brought the beginning of high-profile hedge-fund fraud. As investors became infected with the hedge-fund bug, so did ambitious fund managers who wanted to take advantage of this new demand. In-

5 The first published instance of this proposal can be found in Peter S. Kim, Navigating the Safe Harbors: Two Brightline Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense. 2008 COLUM. BUS. L. REV. 657.

6 Nathan Bryce, Hedge Funds, Liquidity and Prime Brokers, 13 FORDHAM J. CORP. & FIN. L. 475, 488.

7 Since the SEC's authority to regulate securities firms only intends to protect small retail investors, hedge funds are mostly unregulated and do not need to register with the SEC. See John Khambu, Til Schuemann, & Kevin J. Stiroh, Hedge Funds, Financial Intermediation, and Systemic Risk. ECON. POL'Y REV., Dec. 2007, at 2.
instead of coming clean to their investors with their failed investments, some managers engaged in elaborate Ponzi schemes, named after the great 1920's swindler Charles Ponzi, to hide their losses from investors. Ponzi schemes involve misstating returns on investments to old investors in order to gain new investor capital. This capital is then used to pay for the losses on original investors' positions. Usually the additional capital is simply invested in hopes of recouping the original loss.

Michael Berger began operating Manhattan Investment Fund (MIF) in early 1996. Berger intended to sell the equities of technology stocks short (which stocks, at the time, were trading at astronomical price-earnings multiples). The strategy failed miserably: during its four years of operation Berger's fund lost over $300 million. To conceal these huge losses, Berger engaged in the Ponzi scheme with the hope that he would eventually make money for his investors. In the mean time, he used the fraudulent statements of the fund's performance to persuade new investors to provide more capital to the fund. This capital was used to cover the losses of the original investors. When the lie had grown too large, Berger admitted to the fraud after an investigation by the SEC in 2000. Soon afterwards, MIF declared Chapter 11 bankruptcy.

III. THE CASE AGAINST B E AR S T E ARNS SEC URITIES

Soon after declaring bankruptcy, the creditors of MIF brought legal action against Bear Stearns, the fund's prime broker, seeking

9 Id.
compensatory damages for Bear Stearns’s knowledge of and assistance of the fraud. Bear Stearns won this case, successfully refuting the assertion that it substantially assisted in the fraud. 11 Although Bear Stearns was not legally liable for the losses incurred by investors in MIF, the various assets held by the fund, much of which were tied up in their positions with Bear Stearns, were distributed through the bankruptcy courts. Helen Gredd, trustee of the fund's creditors, filed in the Southern District of New York’s Bankruptcy Court to have various assets held by Bear Stearns transferred to the fund’s creditors under Section 548(a)(1)(A) of the Bankruptcy Code. Of the payments sought by the trustee in the adversary proceeding, the debate centered on Count I, which sought $141.1 million in margin payments transferred to Bear Stearns in the year before the commencement of the Chapter 11 proceedings.

Section 548 allows a trustee to “avoid transfers” of—or regain the rights to—any fraudulent transfer in which a party has an interest “provided that the transfer was made with an actual fraudulent intent or with the badges of fraud constituting constructive fraud of the debtor's creditors.” 12

The Bankruptcy Code allows for two major exceptions to Section 548 for certain parties. Bear Stearns asserted both of these exceptions, the stockbroker defense and the good faith defense, in its arguments. This Article will concede to the court’s ruling on the stockbroker defense in order to focus on the issue of whether the


transfers were accepted in good faith.\textsuperscript{13} The good faith defense in Section 548(c) of the Bankruptcy Code exempts parties who accepted transfers of funds, regardless of their fraudulent nature, "for value and in good faith". This defense is an affirmative defense, meaning that the burden of proof rests upon the transferee. Judge Lifland of the Bankruptcy Court rejected Bear Stearns's arguments that it had accepted the payments in good faith, and summary judgment was awarded to the trustee.\textsuperscript{14}

This decision was reversed on appeal, however, when Judge Naomi Buchwalz conceded, "Bear Stearns took a variety of steps to uncover the truth about the Fund. We cannot say that no reasonable jury could find that Bear Stearns's actions were diligent."\textsuperscript{15} In June of 2008, the jury found that the firm had acted in good faith, ending the seven-year case and the roller coaster of decisions that had ensued.

IV. An Analysis of Good Faith in Bear Stearns's Case

Why did the bankruptcy court's original decision rule that Bear Stearns had not accepted the transfers in good faith? To access the safe-harbor of the good-faith provision of the bankruptcy code, a clearing firm must meet two criteria: (1) the disputed transfer was

\textsuperscript{13} Many of the players in the primer-brokerage industry and groups of lawyers associated with the industry have questioned the reasoning, both prima facie and from a public policy perspective, of the court's ruling that prime brokers are "initial transferees" and thus are liable for accepting payments made to defraud. If these brokers are not initial transferees (the stockbroker defense) or the payments are not made fraudulently, then the brokers are released from liability. For the sake of the analysis of the good-faith defense in context of the Bear Stearns case, the Article will not discuss further the arguments relating to these first two conflicts in the case. Rather, the Article will concede, purely for the benefit of presentation, that Bear Stearns (and prime brokers in general) can be considered an "initial transferee" and that all payments received by Bear Stearns during the period in question were fraudulent, and, therefore, that the stockbroker defense is unavailable to Bear Stearns.

\textsuperscript{14} \textit{Supra} note 12, at 526.

\textsuperscript{15} Gredd v. Bear, Stearns Sec. Corp. (\textit{In re} Manhattan Inv. Fund, Ltd.), 397 B.R. 1, 64 (Bankr. S.D.N.Y. 2007).
accepted by the broker for value and (2) the broker accepted the transfer in good faith.\(^\text{16}\) Since there was no contention against the acceptance of the funds for value, this Article will only focus on what circumstances constitute “good faith.”

\textbf{A. What Really Is the Good Faith Defense?}

In its ruling that found Bear Stearns did not accept these transfers for margin payments in good faith, the court defined good faith in the following manner:

“Good faith” under 11 U.S.C.S. § 548(c) includes not only honest belief, the absence of malice, and the absence of design to defraud or to seek an unconscionable advantage, but also freedom from knowledge of circumstances which ought to put the holder on inquiry. The presence of any circumstance placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith unless investigation actually disclosed no reason to suspect financial embarrassment.\(^\text{17}\)

The Court found that Bear Stearns was “on inquiry” and that it had not done enough investigation to clear itself of the responsibility of not accepting fraudulent payments.

In its own bankruptcy-court case, Bear Stearns, in its use of the good faith defense, had the burden to prove that it had accepted the margin-payment transfers without knowing (or without having the responsibility to find out) that the transfers were fraudulent in nature. Outside of U.S. Bankruptcy Court, however, Bear Stearns would have no affirmative duty to prove good faith.\(^\text{18}\) This affirmative requirement (with the burden of proof falling on the transferee) is unique to bankruptcy law; common New York law requires that the transferor prove that transfers were not made in good faith, as

\(^{16}\) 11 U.S.C.S. § 548(c).

\(^{17}\) Supra note 12, at 523.

\(^{18}\) Kim, supra note 5, at nn.53 & 54.
do several other states. Its burden was to refute the two assertions of the Trustee regarding the good faith defense: that it had been "on inquiry" and that it had not performed sufficient investigation.

**B. Did Bear Stearns Ignore Facts after Being on "Inquiry Notice"?**

Under the court’s definition of good faith, the entity that accepts funds as a transferee can only accept transfers in good faith if it is not "on inquiry notice" of "any" circumstance affecting the financial condition of the transferor.

What is inquiry notice? The MIF case refers specifically to a cocktail party at which a Bear Stearns employee, unaffiliated with the firm’s arrangement with MIF, conversed with an employee of an investment management firm who was discussing the performance of MIF. The MIF employee, inadvertently aware that the firm had not been performing well in its accounts with Bear Stearns, appealed to others within Bear Stearns concerning the discrepancy. Bear Stearns held a conference call with MIF manager Michael Berger in which Berger claimed that more than one prime broker had serviced the fund, a claim that both parties in the bankruptcy case agree to be a plausible circumstance.

Bear Stearns, in light of Mr. Berger's explanation, did not initiate an investigation or report to the SEC until, in 2002, it became fully aware of the fraud and reported it to the SEC. It did, however, question and notify MIF’s auditor, the entity responsible for issuing opinions of the fairness of MIF’s financial reporting. After learning of the discrepancies between their own records and the performance related to them by a client of the fund, Bear Stearns was likely on inquiry notice. However, because Berger’s explanations were plausible and the auditor had been contacted, Bear Stearns could not have willfully ignored the fraud.

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19 United States v. McCombs, 30 F.3d 310, 326 (2d Cir. 1994).
20 Supra note 17.
21 Anderson, supra note 4.
22 Supra note 12, at 526.
23 Supra note 15, at 8–9.
The February 2007 bankruptcy court ruling held that Bear Stearns was required to investigate the possible fraudulent transfer at the point when they became aware of facts that suggested a problem. For example, the court argued that the firm must be "aware of sufficient facts concerning the debtors' precarious financial situation to place the [entity] on inquiry notice of the debtors' insolvency and looming bankruptcy." Therefore, Bear Stearns was required to show that no evidence from the exchange at the cocktail party—and the events that followed as a result—indicated that any facts were established to put Bear Stearns on inquiry notice. One often quoted case describes such facts as "actual, open, and visible" inconsistencies with what has been recorded. Bear Stearns's conversations at a cocktail party, explained away by the nefarious Berger, were—while certainly inconsistent with reality—not actual, open, visible facts. The facts established at the party were only that there existed a discrepancy in what one investor was describing informally and what the employee, who was not staffed on the relationship between Bear Stearns and MIF, had heard at the office. No documents had been shown and no visible inconsistencies had been established—this is made clear by the fact that Berger provided a completely plausible explanation for the discrepancy in the conference call occurring shortly after the exchange at the party. It seems obvious that, if financial statements were easily available to Bear Stearns after the conference call to verify Michael Berger's explanation, the statements would be consulted in the event of an inconsistency in the explanation given by Berger. While it might be clear that the financial statements indicating the number of prime brokers could have been consulted, it is equally clear that the prime brokers have no outside standard of conduct or due professional care by which they would be required or expected to look at such statements.

In response to the defense that Berger's explanation was sufficient to take Bear Stearns off inquiry notice, the February 2007 decision argues that Bear Stearns was not satisfied with this expla-
nation, citing further investigations by Bear Stearns into the Fund's performance. The argument relies on the exhibition of a discomfort with Berger's explanation; the discomfort, the argument contends, shows that Bear Stearns was willfully ignoring or postponing proper investigation into the nature of transfers from the fund. There is no other concrete evidence, however, that Bear Stearns was uncomfortable with or had qualms about Berger's explanation. With no outside standard by which to base a requirement for checking the financial statements, the presence of inquiry notice could require the prime broker to engage in any combination of arbitrary due diligence. Bear Stearns should not be assumed here to have been on inquiry notice simply because it chose to proceed cautiously.

Even if these conversations ought to have prompted Bear Stearns to undertake a more thorough investigation, the Ninth Circuit Court of Appeals recently ruled in Betz v. Trainer Wortham, Inc. that certain circumstances could delay the necessity for action under inquiry notice. This particular case allows for investors to delay the point of inquiry notice if the fraudster answers questions and allays the fears relating to a particular issue. The judge notes that subsequent actions by Bear Stearns employees with regard to MIF show that they were not comfortable with Berger's explanations. In any case, the test applied in Betz implies that Bear Stearns ought to have been given more time to investigate the fraud (which it eventually did) before it could be considered to be on inquiry notice.

Willful ignorance is also expressly used as a test for litigants applying the good faith defense. After being on "inquiry notice" the judge quotes In re World Vision Entertainment, Inc. to establish the claim that Bear Stearns exercised willful ignorance. The case law applied in this case denies the good faith defense for entities that "put on 'blinders' prior to entering into transactions with the debtor and claim the benefit of 548(c)." The court applies this test to an in-

27 Supra note 12, at 525.
28 Heide Betz v. Trainer Wortham, Inc., 486 F.3d 590 (9th Cir. 2007).
surance agent who participated in a fraudulent program to sell promissory notes for which he was being paid a high commission. The agent was uneducated, unlicensed, and broke the law in selling the debt securities. Not only did the agent have much to gain by putting up "blinders" and ignoring the financial position of the originator of the securities, he had an obligation to represent these investments in promissory notes to his clients. He had, therefore, in licensing requirements and professional requirements, a duty to look at the financial statements and to assure that the program was sound, safe, and legitimate.

Bear Stearns, on the other hand, had no legal obligation to review the financial statements of the Manhattan Investment Fund. It had no interaction with its investors, who, interestingly, were quite different from the elderly people defrauded in the World Vision Entertainment case. Those at Bear Stearns were educated enough to know what particular explanations and claims would be plausible and which would not be plausible. At no point was Bear Stearns found to have been dishonest or untruthful in its dealings with MIF or with the SEC investigation. On the other hand, Weaver, the insurance agent on trial in the aforementioned case, had been caught in a lie about his due diligence regarding the legitimacy of the sales operation. He argued that he had researched securities law and had understood the requirements for selling the promissory notes under state law. After considering that the insurance agent had not been performing appropriate due diligence (which, importantly, is considered in context of his legal duties to his customers and the nature of the business itself), the judge granted the contention that Weaver had been willfully ignorant of the Ponzi scheme involved.

Unlike the business activities of Weaver, the nature of the Bear Stearns business was not to make any qualifications or recommendations pursuant to the financial position of the company. It is only under bankruptcy law that any consideration of such knowledge is tak-
en into consideration. The knowledge in Bear Stearns’s case would have to be incidental, since, as a prime broker, its job is to deal with high-risk investments that can, and often do, fail. Bear Stearns’s job is to keep tabs on the margin rates so that there is sufficient collateral to cover positions in a customer’s account. In the industry, Bear Stearns is not asked to look at the solvency of a hedge-fund client as an accept-or-do-not-accept issue. Bear Stearns is solely concerned with the solvency of the account alone. While Weaver may have been required to perform diligence then “based upon verbal assurances from the debtor”, this was a requirement of doing business in the industry.\footnote{Id. at 650.} In Bear Stearns’s case, the judge held that they had “put on blinders” by not parsing the financial statements in their possession to verify Berger’s claim. Weaver’s negligence, in the view of the judge, was to avoid looking at basic agreements and credit checks that, as an “experienced insurance agent”, he should have recognized.\footnote{Id. at 651.} The judge noted, “Weaver’s cursory and almost non-existent investigation indicates that he did not want to know more.”\footnote{Id.} Hence, Judge Lifland in the citation of this case implies that Bear Stearns ought to have “not wanted to know more”. Bear Stearns, however, held a conference call and continued to correspond with MIF’s auditor, Deloitte and Touche, regarding the fund’s business. This shows affirmatively that, while they may have had a question for Mr. Berger, this question was answered. The inquiries made on behalf of Bear Stearns did not represent an attempt to “not know more”. They showed that Bear Stearns was cautiously moving forward with the relationship, recognizing that the risk was higher but continuing to act in accordance with their duties as MIF’s prime broker.

Expert testimony in the WVE case, accepted and relied upon by the judge in his application of the “blinder” test, argued that a broker “has a minimal duty of care owed to investors.”\footnote{Id. at 644.} The judge’s application of the good faith defense shows that the aforementioned

\footnotesize{
34 Id. at 650.
35 Id. at 651.
36 Id.
37 Id. at 644.
}
norms of duty for investigating one’s clients determine the level of required diligent inquiry:

The clients rely on the brokers for financial advice. Therefore, the issue is whether these brokers act in good faith if they make no or little effort to verify the legitimacy of the debt instruments they market. Stated differently, can a broker simply rely on promises made by a dishonest and fraudulent debtor and still act in good faith? . . . The Court first must define the steps a prudent broker acting in good faith would take before selling the debtor’s notes. Then, the Court must determine if the defendants took these steps.

Prime brokers, for economic reasons, take different steps in “acting in good faith” than a broker for the elderly takes. It would be entirely appropriate for a prime broker to assume that hedge-fund clients perform their own due diligence and, in exchange for a potentially higher return, assume the risks involved in such an arrangement.

C. Did Bear Stearns Perform Sufficient Due Diligence?

The court argues that, although Bear Stearns held a press conference with the fund manager who assured that Bear Stearns was not the only prime broker, Bear Stearns should have examined the financial statements that reported that Bear Stearns was the only prime broker. The court, citing case law, holds that “if the circumstances would place a reasonable person on inquiry of a debtor’s fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent.” The court argues that the fact that Bear Stearns did not look at the “easily attainable” financial statements shows that their inquiry was not diligent.

There is no articulation in the case of whether these financial statements were recent and whether Bear Stearns regularly received

38 Hayes v. Palm Seedlings Partners (In re Agricultural Research and Technology Group, Inc.), 916 F.2d 528, 535–36 (9th Cir. 1990) (citing Sanitary Ice Vending Co. v. Harris (In re Polar Chips Int’l, Inc.), 18 B.R. 480 (Bankr. S.D. Fla. 1982)).
(or even reviewed) copies of these statements. Although it is unclear why Bear Stearns would not catch this disclosure in the financial statements, the circumstance in which Bear Stearns found itself “on inquiry” in the view of the court was very informal. Since this information was circulating at a cocktail party, it would seem entirely appropriate for Bear Stearns to engage in a proportionally informal investigation of the claim. The conference call with Michael Berger held soon after the cocktail party revealed a completely plausible explanation for the discrepancy discussed as a result of the cocktail party. Both parties in this bankruptcy case agreed that Berger’s explanation was plausible. Therefore, with no legal duty to perform due diligence on each hedge-fund client’s relationship with its clients and other prime brokers, it would be counterintuitive for these firms to regularly perform due diligence for the sole purpose of preventing transfers in a possible bankruptcy proceeding.

The law confirms this intuition. In 2002, for example, an analogous bankruptcy case involving Harrah’s Entertainment found that Harrah’s was responsible for finding “easily obtainable information” relating to the bankrupt party because this information was required to be collected under Louisiana law. Bear Stearns however, had no such requirement.39

V. FUTURE IMPLICATIONS OF THE BEAR STEARNS RULING

Prime brokers everywhere have been scrambling to understand what these recent rulings mean for their business. In the midst of downsizing and deleveraging in the investment banking industry, prime brokers need to understand the risks involved in engaging in business with hedge funds. Even if Bear Stearns ought to have reported the MIF fraud earlier, its case demonstrates that prime brokers either need additional guidance to know the extent of due diligence required or they need to be allowed to access the good faith defense when normal industry practices are followed.

Peter S. Kim of the Columbia Business Law Review, analyzing the case before Bear Stearns succeeded in its jury trial, writes that

prime brokers will find significant confusion about what this means for their risk-management procedures:

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. 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? 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.40

Kim’s point that prime brokers are left in the dark regarding risk-management procedures requires a closer look. What did Bear Stearns not do in the case of MIF that it should have done in order to uncover the fraud? Perhaps speculation mentioned by Peter Kim will have to be performed by each prime broker with regard to every hedge-fund client. The cost of such speculation and due diligence can be very high.

In addition, due diligence can be very difficult. For example, the bankruptcy court originally found that Bear Stearns would be on the hook for their margin payments even if the payments were originally made without fraudulent intent. In these Ponzi schemes performed by hedge funds, it is very unclear when or if a hedge-fund manager decides to operate a Ponzi scheme simply to cover their losses. According to previous rulings, a Ponzi scheme is fraudulent from its outset. The industry will struggle on how to know, through due diligence, to disregard margin payments “regardless of whether [other] payments were made to early investors or whether the debtor was engaged in a strictly classic Ponzi scheme.”41

40 Kim, supra note 5, at 683–84.
41 In re Manhattan Investment Fund Ltd., 310 B.R. 500, 509 (Bankr. S.D.N.Y. 2002).
While Howard Schiffman, the lawyer for the Securities Industry and Financial Markets Association, has rightly proclaimed that the jury’s decision in the Bear Stearns’s case can help to establish “fact patterns” for the determination of future cases, it will still be important to allow for a bright line based on industry norms so that prime brokers can continue to operate in such a precarious market with the confidence that their current investigation policies for clients are sufficient protection for bankruptcy proceedings. These changes will prove necessary as high-profile cases such as the Bayou LLC case against Goldman, Sachs & Co. proceeds and as hedge funds remain at the mercy of the courts.

V. Conclusion

The due diligence requirement under the good faith provision was incorrectly applied in the original Bear Stearns ruling and would have placed undue risk on prime brokers. Not only does analysis of the case reveal that Bear Stearns, under normal conditions, responded reasonably to the inconsistencies it found in conversations with MIF’s clients, but it shows that, if a judge could rule one way and the jury another, prime brokers still face the risk that courts will realign the risk distribution intended by policymakers in other cases. Peter Kim states, “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.”

Although Bear Stearns eventually triumphed in its jury trial, prime brokers will still be in desperate need for concrete guidance on due-diligence procedures. The court’s own interpretations of


44 Kim, supra note 5, at 690.
the good faith defense support a standard of duty based on industry norms and expectations of due diligence, as advocated by Kim. For prime brokers, policymakers have consistently shown that the risk for hedge-fund failure—and, as a result, the burden of due diligence—ought to rest with investors and their representatives who, according to the SEC, ought to be able to manage the risk in their own portfolios.