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# Hot Topics in the Lehman and Madoff Broker-Dealer Liquidations

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## Enhanced Prime Brokerage Accounts

- Customer Account Agreement Prime Brokerage
  - Parties: Lehman Brothers Inc. (LBI), Lehman Brothers International Europe (LBIE), Lehman Brothers Finance, S.A., Lehman Brothers Special Financing Inc., Lehman Brothers Holdings Inc. and any of their subsidiaries, parents, affiliates, etc.
  - One-sided agreement. Defaults for customer; no defaults for Lehman
  - Prime brokerage account opened pursuant to this Agreement opened at LBI. Contains at least SEC's "minimum net equity"
  - Security Interest granted to all Lehman entities
  - Rehypothecation of securities in margin accounts. What if no margin loans or other borrowings outstanding? (Refco decision: 586 F. Supp.2d 172 (S.D.N.Y. 2008))

## Enhanced Prime Brokerage Accounts

- Ancillary Agreements – “Enhancement”
  - Global Master Securities Lending Agreement (GMSLA) or Overseas Securities Lending Agreement (OSLA) with LBIE (bilateral, but generally for loans of securities by LBIE to customers)
  - Global Master Repurchase Agreement with LBIE (MRA)
  - Margin Lending Agreement (MLA) with LBIE contains right to cause transfer of securities collateral to account at LBIE in amount determined by LBIE and authorizes LBI to make the collateral transfers for MLA, GMSLA, OSLA and MRA

## Enhanced Prime Brokerage Accounts

- Ancillary Agreements – “Enhancement” (cont.)
  - Amendment to Margin Lending Agreement to Deal with MiFID Implementation Rules
    - Client Money Rules
    - Ability to Waive Protections
  - If any borrowing from LBIE, all securities could be moved to LBIE
  - Rehypothecation by LBIE
    - Legal status of rehypothecated securities
    - Right to rehypothecate vs. actual rehypothecation
    - Availability of rehypothecation reports

## Enhanced Prime Brokerage Accounts

- Claims Against Lehman Entities
  - If no borrowings, did LBI have right to transfer securities to LBIE? If not, arguably LBI's customer should be treated as a "customer" under SIPA and should have priority status and a share of customer property on hand at LBI
  - Even if LBI had right to transfer securities and there is no SIPA customer status, joint and several liability of all Lehman Entities. All "parties" to prime brokerage agreement
  - Did LBI have authority to bind all Lehman parties?
  - File proofs of claim against all U.S. Lehman Entities
  - Consider claim in Switzerland against Lehman Brothers Finance S.A.
  - Assert claim against LBIE

## Customer Property

- SIPA – Customer property allocable to customer claims only
  - Customer is a person or entity with a securities account
- Customer's Deficiency Claim – shares pro rata in proprietary LBI assets with non-customer creditors of LBI
- SIPC Coverage (\$100K/\$500K) is on top of customer's allocable share of customer property until customer receives 100%; Supplemental Insurance Coverage (CAPCO)

## Customer Property

- LBIE Customer Property
  - Segregation
  - Rehypothecation
- No securities in BMIS
  - Characterization of cash and clawback recoveries as customer property
  - Non-customer creditors of BMIS will otherwise share in recoveries

## BMIS Claims Processing

- Because there are no securities to be returned to customers, no difference between March 4 preferred claim date and July 2 absolute bar date
- Trustee believes BMIS had good records of actual cash in and cash out, but has not gone through all files yet
- Even though no securities and only cash was stolen, SIPC will pay based on \$500K securities limit, not \$100K cash limit
  - Consistent with decision in New Times Securities Services, Inc., 371 F.3d 68 (2d Cir. 2004)
  - New Times also holds that where securities positions were fictional, claims are payable based on cash paid in and not on fictitious profits, interest, etc.



## BMIS Claims Processing

- SIPC will advance money once the trustee and SIPC are satisfied that claimant has put more in than he has taken out and there is no clawback exposure
  - Trustee has announced he will generally pursue clawback claims for fictitious profits
  - Not clear whether he will pursue clawback claims on withdrawals of original investments – “good faith” defense may be too strong

## Timing of Distributions

- BMIS – While SIPC advances can be made as quickly as the trustee and SIPC satisfy themselves as to a particular claimant's entitlement, customer property that may be recovered cannot realistically be distributed until after the July 2, 2009 bar date, when the universe of potential claims is known
- Much of the money to be distributed to creditors in excess of the SIPC advances will come from clawback recoveries. Trustee has two years from the December 11, 2008 filing date to commence clawback litigation
- Partial distributions are possible, but it may take years before all of the recoverable assets are distributed to claimants

## Timing of Distributions

- LBI – Final claims bar date of June 1, 2009. As of Feb. 25, 2009:
  - Over 135,000 customer accounts with over \$140B of customer property transferred to Barclays and Neuberger Berman
  - Over \$3B of prime brokerage account assets consensually transferred
  - Claims filed for more than 80,000 potential customers and other creditors
  - LBI may hold collateral for LBIE and others under prime brokerage agreements

## Timing of Distributions

- LBIE – Administrators liable for improper distributions; process moving at a glacial pace
- LBIE had relationships with custodians throughout Europe
- LBIE Administrators have applied to the English court for permission to propose a Scheme under which payment of Trust Property claims can be expedited
- Ultimately, LBIE will have to be placed in a liquidation proceeding for remaining deficiency claims of customers and other unsecured creditors to be paid out

# Clawbacks

- Trustee Actions
- Two Types Of Clawbacks
  - Preferences
  - Fraudulent Conveyances
    - Preliminary Questions
      - What Law will be applied (Federal Bankruptcy Law or State FCL)?
      - Statute of Limitations
      - Burden of Proof

## Preferences

- Why Especially Likely to Occur in Ponzi Scheme Context
- Preference Actions
  - Trustee may seek to recover conveyances made in the 90 days before the filing
  - Defenses

# Fraudulent Conveyances

- TWO TYPES:
  1. Intentionally Fraudulent Transfers
    - Federal courts in New York presume any transfer made in furtherance of a Ponzi scheme to have been made with actual fraudulent intent as a matter of law
  2. Constructively Fraudulent Transfers

## Fraudulent Conveyances

- Section 548(c) – Can retain transfer if
  - Good Faith
  - “For Value”
  - Principal vs. Profits – key distinction
  - “Fictitious” profits paid by a Ponzi Scheme...are they ever for “value”?
    - Interest?



## Fraudulent Conveyances

- Some Leading NY Ponzi Scheme/Fraud Cases
  - In re Bayou Group, LLC, 396 B.R. 810 (Bankr. S.D.N.Y. 2008) – on appeal
  - In re Manhattan Inv. Fund Ltd., 397 B.R. 1 (S.D.N.Y. 2007)
  - In re Bayou Group, LLC, 362 B.R. 624, 626 (S.D.N.Y. Bankr. 2007)
  - In re Churchill Mortgage Inv. Corp., 256 B.R. 664 (S.D.N.Y. 2000)

## Red Flag Litigation

- Good Faith Withdrawals
- “Red Flags” will become common parlance in these cases
  - The Oft-Alleged Madoff “Red Flags”
  - Mitigating Factors
  - Should be Numerous Questions of Fact but...

## Fraudulent Conveyance FAQs

- What will Trustee do with SIPC payments if there is a potential clawback?
- When will clawback claims be asserted?
- Who are the most likely targets for a clawback claim?
- Why should diligent investors be in a worse position if they investigated and found they had invested in a Ponzi scheme?

## Fraudulent Conveyance FAQs

- What if you are an indirect investor – are you subject to clawbacks?
  - Feeder Fund Bankruptcies?
- What if I had multiple accounts at BMIS and withdrew only some money from one account?
- What is the extraterritorial effect of U.S. fraudulent conveyance law?

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