



LEGAL & REGULATORY

PONZI SCHEMES AND THE SUBSEQUENT BATTLE AMONG VICTIMS



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LITIGATION

Ponzi schemes and the subsequent battle among victims | BY PETER FELDMAN

A Ponzi scheme is a financial fraud in which the scheme operator diverts certain of the proceeds from new ‘investors’ to existing ones, as purported return on investment – in other words, so-called fictitious profit. In this way the scheme operator constructs the illusion of legitimacy that is required to induce new victims to invest, avoid demands by existing victims for return of principal and maintain the fiction on which the fraud is based.

Ponzi schemes currently are of particular interest, largely as a result of the enormity of the Madoff fraud, and the subsequent liquidation of the broker-dealer through which that fraud was conducted. However, since at least 1924, when the Supreme Court considered the scheme masterminded by Charles Ponzi himself, the legal system has struggled with the unfairness caused by Ponzi schemes, and the inherent conflicts among the victims left in its wake.

Although courts employ remedies intended to achieve equality in recovery among victims, the very design of Ponzi schemes – in which new victims fund the fictitious profits that existing victims receive – may result in certain victims believing that efforts at equality actually favour one victim group over another. Victims that received fictitious profits (so-called ‘winners’) fight to retain what they received, in order to avoid increasing what may already be mammoth losses. Victims that did not receive fictitious profits (so-called ‘losers’), fight, either directly or indirectly through estate fiduciaries, such as trustees or receivers, to obtain a share of the funds received by the winners. But new victims too may be subject to the restraints imposed by the quest for equality, by being prevented from recovering funds they were fraudulently induced to transfer, even though the funds can be identified through tracing.

Operating under the precept that equality is equity, courts have often employed various mechanisms in their efforts to fashion relief:

Net loss method. In legal proceedings under state law (e.g., receiverships) and federal law (e.g., bankruptcy cases and SEC actions), courts have employed the net loss method to distribute to victims assets recovered from the Ponzi scheme. Under the net loss method, each victim’s pro rata share of the recovered assets is often derived by deducting from the victim’s ‘investment’ (i.e., the funds transferred to the fraudster) all

or a portion of the amount of fictitious profits or other payments the victim may have received through the scheme. The net loss method is often the subject of challenge by both winners and losers. For example, winners may complain that their pro rata share of the assets to be distributed is inappropriately reduced. Losers may complain that the winners will garner a higher percentage recovery when both their fictitious profits and their share of the recovered assets are combined.

Disgorgement. Perhaps of greater concern to winners than merely netting their fictitious profits against their principal investment is the prospect that they will be required to disgorge all or a portion of their fictitious profits. These claims often arise in fraudulent conveyance actions under state or federal law, particularly as elements of a fraudulent conveyance claim may be deemed satisfied as a matter of law because of the very nature of a Ponzi scheme (for example, a Ponzi scheme may be deemed as a matter of law to be insolvent from its inception). In certain instances, winners may be required not only to disgorge fictitious profits, but in addition, charged pre-judgment interest on the amount to be recovered.

Good faith. ‘Good faith’ may be an affirmative defence to a fraudulent conveyance claim. A Ponzi scheme victim found to have been in ‘good faith’ may be allowed to retain all fictitious profits up to the amount of the victim’s investment, being required to disgorge only those fictitious profits in excess of that amount. However, a victim, even if innocent of any criminal wrongdoing, may nonetheless be unable to establish good faith if the victim is found to have had sufficient knowledge to place the victim on inquiry notice of the fraud. For example, if the victim ignored red flags indicating the existence of the scheme, yet continued to receive fictitious profits anyway, it may be difficult for the victim to establish a good faith defence. In addition to other legal challenges, a finding by a court that the victim was not in ‘good faith’ may result in disgorgement of all fictitious profits, not just those in excess of the amount of the victim’s investment.

Tracing. Often the victim of a fraud may be entitled to impress a constructive trust on funds the victim was fraudulently induced to transfer if the funds can be identified through tracing. However, constructive trusts

are equitable in nature, and in a Ponzi scheme courts may be reluctant to grant this relief on grounds of equality, believing it to be inequitable to favour one victim of the scheme over another simply because, by sheer luck, that one victim's funds can be traced while another victim's cannot.

Further considerations

While claims against the Ponzi fraudster, his associates, and other potential parties may take priority in the aftermath of a Ponzi scheme, at some point in the legal process, either in connection with distribution of recovered assets or otherwise, victims of Ponzi schemes may be the subject of what may be difficult legal proceedings. There are steps, however, that a practitioner representing a victim can consider taking. As with any other matter, a full understanding of the relevant facts is required – and with Ponzi schemes this necessarily includes both an accounting of the client's transfers to and receipts from the scheme as well as a full understanding of the client's relationship with the fraudster. It may also be appropriate to consider not only such evidence of

the client's 'good faith,' but also the evidence bearing upon the asserted good faith of other victims.

Additionally, in the appropriate case, when recovered assets are being distributed, there may arguably be grounds to assert that an alternative means of determining pro rata share is more equitable than 'net loss.' Subject to applicable law, affirmative defences may be also available (e.g., statutes of limitation for older transfers) and constructive trusts may perhaps still be considered under the right facts (for example, if the funds in issue were not under the fraudster's control). Arguments may be available based upon statutory construction, such as the provisions of Securities Investor Protection Act, which may apply to the liquidation of broker-dealers, like the broker-dealer in the Madoff fraud.

The financial distress of 2008-2009 stripped the illusion of legitimacy from ongoing Ponzi schemes. The use of Ponzi schemes may have been more widespread than imagined. The legal fallout from these schemes will be felt for years to come. ■

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For twenty-five years Peter Feldman has represented financial institutions and other clients in complex legal matters, including claims concerning fraud, director and officer liability, bankruptcy, lending arrangements, financial instruments, and other contract disputes.