A REVIEW OF RECENT INVESTOR ISSUES IN THE MADOFF, STANFORD AND FORTE PONZI SCHEME CASES

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Note from the Editors: *This article was solicited from the authors following Mr. Pozza's presentation on Ponzi schemes at the Midwest Securities Law Institute Symposium (which JBSL is an annual participant). New Ponzi schemes are discovered more frequently than ever before, most likely due to the difficult economic climate that has challenged both honest investors and criminal swindlers alike. Mr. Pozza, along with his co-authors, graciously agreed to share their knowledge on the topic for our law journal and its readers. To read the transcript of Mr. Pozza's presentation and audience interaction, see pages 248 through 258 of this publication or by citation search at 10 J. Bus. & Sec. L. 248.*

INTRODUCTION

As we enter a new decade, the catastrophic declines in asset values and disruptions in the financial markets are, we hope, behind us. Americans have witnessed the disappearance of long established financial institutions such as Lehman Brothers and Bear Stearns, mergers of other major institutions, unprecedented governmental market intervention, evolution of investment banks into commercial banks, and a recasting and growth of the financial regulatory system. Positive performance of capital markets in the latter half of 2009 has offered hope to millions of investors that the worst is over.[1]

For another class of investors, the market recovery and improvement in asset values will have little impact. These investors are the victims of the numerous Ponzi schemes which came to light during the recent market crises.[2] Many of these investors are retired and have lost all or a significant portion of their hard earned retirement savings and are destitute.[3] Charities were hard hit.[4] Even hedge funds run by sophisticated managers suffered losses.[5] The unprecedented market conditions were a shock to all but even more so to those who learned that their investments had not simply declined in value but, rather, were fictitious and did not exist.[6]

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1. *See, e.g.*, Tom Lauricella, *For Rebuilt Markets, a Test in 2010*, WALL ST. J., Jan. 5, 2010, at R1.

2. *See, e.g.*, Kevin McCoy, *Recession Forces Unraveling Ponzi Schemes into the Open*, USA TODAY, Apr. 17, 2009, at 6A.

3. *E.g.*, Lee Ferran, *Madoff's Alleged Ponzi Scheme Destroys Life Savings, Sends Elderly Back to Work*, ABC NEWS, Feb. 10, 2009, http://abcnews.go.com/TheLaw/story?id=6838043&page=1.

4. *E.g.*, David Donell & Eric Rieder, *Charities Face Greater Threat from Ponzi Schemes Than Lost Investments*, THE HUFFINGTON POST, June 30, 2009, http://www.huffingtonpost.com/david-donell/charities-face-greater-th_b_223088.html.

5. *See, e.g.*, Matthew Goldstein, *Madoff Losses Will Change Hedge Funds*, BUS. WEEK, Dec. 16, 2008, http://www.businessweek.com/magazine/content/08_52/b4114000908444.htm.

6. *See* Ferran, *supra* note 3. *See generally* Jack Healy & Diana B. Henriques, *Madoff Aide Reveals Details of Ponzi Schemes*, N.Y. TIMES, Aug. 12, 2009, at A1 (detailing methods used to conceal the Madoff Ponzi scheme).

The Ponzi schemes that have come to light are, of course, varied. Some are national in scope and were conducted for years.[7] Others are local or regional and shorter in duration.[8] The Bernard Madoff tragedy, estimated at over $50 billion, is the largest, and longest in duration of the recent schemes.[9] It involved fictitious securities transactions never carried out at Madoff's broker-dealer which were shown on customer account statements as real investments.[10] Another huge scheme involved the Stanford International Bank and related Stanford entities.[11] Approximately $8 billion in fraudulent certificates of deposit were issued by Stanford International Bank based in Antigua and sold to various investors through Stanford companies.[12] A scheme conducted by Joseph Forte solicited investors to invest limited partnership funds in a securities futures trading account in the name of Forte LP.[13] In late December 2008, Forte admitted to federal authorities that, from at least 1995 through 2008, he had been conducting a Ponzi scheme.[14]

Other recently disclosed Ponzi schemes involve an array of fictitious investments. Marc S. Dreier, an attorney, was sentenced to a 20 year prison term for fraud[15] based on the sale of bogus short term promissory notes, which allegedly provided short term financing for real estate projects.[16] On December 2, 2009, a federal jury found Tom Petters guilty of various federal crimes relating to a Ponzi scheme in which investors provided funding for the purchase of fictitious merchandise which was to be resold to various retail companies.[17] That same day, Scott Rothstein, a Florida attorney, was accused of running a $1 billion Ponzi scheme in which he sold

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7. *E.g.*, Leslie Wayne, *The Mini-Madoffs*, N.Y. TIMES, Jan. 28, 2009, at B1.

8. *Id.*

9. *E.g.*, Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Crossing Borders*, N.Y. TIMES, Dec. 20, 2008, at A1.

10. *See* Healy & Henriques, *supra* note 6.

11. *See, e.g.*, Zachary A. Goldfarb, *SEC Alleges $8 Billion Savings Fraud*, WASH. POST, Feb. 18, 2009, at D1.

12. *Id.*

13. *E.g.*, Press Release, SEC, SEC Charges Joseph S. Forte for Conducting Multi-Million Dollar Ponzi Scheme (Jan. 8, 2009), *available at* http://www.sec.gov/news/press/2009/2009-5.htm.

14. *See, e.g.*, Harold Brubaker, *Joseph Forte's Financial Pyramid Scheme*, PHILA. INQUIRER, Nov. 22, 2009.

15. *E.g.*, Benjamin Weiser, *Lawyer Sentenced to 20 Years for $700 Million Fraud*, N.Y. TIMES, July 14, 2009, at A20.

16. 60 Minutes, *Marc Dreier's $400 Million Scam, the Inside Story*, CBSNEWS.COM, Oct. 4, 2009, http://www.cbsnews.com/stories/2009/10/02/60minutes/main5358948.shtml.

17. *E.g.*, *Update 2 – Tom Petters Found Guilty of Ponzi Scheme Fraud*, REUTERS, Dec. 2, 2009, *available at* http://www.reuters.com/article/idUSN024978920091202.

shares in fabricated legal settlements.[18] Later that month, the *Wall Street Journal* reported on Ponzi allegations involving Timothy S. Durham, who had been featured as a financial superman on the CNBC program "Untold Wealth: The Rise of the Super-Rich."[19]

In Ponzi scheme cases, investor potential for recovery is typically quite limited. Usually most of the money is "gone" having been paid out to earlier investors, spent by the Ponzi schemer on operations, or wasted. Thus, conflicts between investors often arise with those receiving proceeds from the scheme arguing they should be able to keep such proceeds. Those who have received nothing or little back argue that allowing some investors to keep proceeds is unfair.[20]

Focusing on the Forte, Stanford and Madoff cases where investor conflicts are stark, this article will examine the various key arguments and recent legal precedents with respect to the fairness of recovery between investors in a Ponzi scheme. The related issue of availability to defrauded investors of funds from the Securities Investors Protection Corporation ("SIPC") will also be addressed.

I. What Is a Ponzi Scheme?

A Ponzi scheme is a deception in which a person or entity ("Ponzi schemer") solicits and receives money (or its equivalent) from certain investors which the Ponzi schemer pays out to other investors in order to create a misperception of returns on the investment and/or return of the principal invested.[21] Definitions found in judicial decisions often use more provocative terminology.[22] "A 'Ponzi' or 'Pyramid' scheme is a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion

18. *E.g.*, Nathan Koppel, *Rothstein Charged in Ponzi Scheme*, WALL. ST. J., Dec. 2, 2009, at B3.

19. David Kesmodel, *Ponzi Probe Ensnares Indiana Businessman*, WALL ST. J., Dec. 22, 2009, at C1.

20. *See infra* Part III.

21. *See* BLACK'S LAW DICTIONARY 1198 (8th ed. 2004); *see also* U.S. Securities and Exchange Commission, Ponzi Schemes – Frequently Asked Questions, http://www.sec.gov/answers/ponzi.htm (last visited Feb. 14, 2010).

22. *See, e.g.*, Bayou Superfund, LLC v. WAM Long/Short Fund II, LP (*In re* Bayou Group, LLC), 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) ("[T]he label 'Ponzi scheme' has been applied to any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.").

of profitability, thus attracting new investors."[23] Our concern with the more colorful definitions is not for the Ponzi schemer or accomplices but in how such definitions can affect argument and judicial perceptions regarding Ponzi victims and the manner in which to fairly compensate them for losses.

II. CATEGORIES OF PONZI SCHEME INVESTORS

A similar concern should be applied to descriptions of Ponzi scheme investors who are often regrettably characterized as "winners" and "losers."[24] This dichotomy tends to prejudge the equitable collection of funds and distribution to Ponzi victims. In this article, for the purpose of simplification, we have divided Ponzi investors into three categories. First are investors who have provided funds to the Ponzi schemer and have received nothing back. Often these are investors who come in to the Ponzi scheme late, but not always. The second group consists of investors who have provided funds to the Ponzi schemer and have received back some proceeds, whether labeled interest, dividends, profits, return of capital, principal or some other term. The third category consists of investors who have provided funds to the Ponzi schemer and have received back proceeds in excess of the amounts the investors provided to the Ponzi scheme.[25]

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23. Ades-Berg Investors v. Breeden (*In re* The Bennett Funding Group, Inc.), 439 F.3d 155, 157 n.2 (2d Cir. 2006) (citing BLACK'S LAW DICTIONARY 1198 (8th ed. 2004)); *see also* Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1088 n.3 (2d Cir. 1995) ("A ponzi scheme is a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors."(quoting McHale v. Huff (*In re* Huff), 109 B.R. 506, 512 (S.D. Fla. 1989)); Drenis v. Haligiannis, 452 F. Supp. 2d 418, 422 (S.D.N.Y. 2006) ("[A] 'Ponzi scheme[]' [is] a species of fraud whereby an investment fund that is unprofitable uses money from new investors to pay 'false profits' to old investors in order to encourage further investment and sustain the scheme."); Jobin v. McKay (*In re* M & L Bus. Mach. Co., Inc.), 84 F.3d 1330, 1332 n.1 (10th Cir. 1996) ("We have defined a Ponzi scheme as 'an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments.'" (quoting Sender v. Heggland Family Trust (*In re* Hedged-Invs. Assocs., Inc.), 48 F.3d 470, 471 n.2 (10th Cir. 1995) (citing Merrill v. Abbott (*In re* Ind. Clearing House Co.), 41 B.R. 985, 994 n.12 (Bankr. D. Utah 1984)).

24. *See, e.g.*, Ashby Jones, *Should Madoff 'Winners' and 'Losers' be Compensated Equally?* Feb. 3, 2010, LAW BLOG, WSJ.COM, http://blogs.wsj.com/law/2010/02/03/should-madoff-winners-and-losers-be-compensated-equally/tab/article/ (last visited Mar. 19, 2010).

25. There are additional categories such as persons who never contribute funds but receive out-right payments, bribes or gifts from the Ponzi schemer and persons who receive back exactly the amount invested. There are probably innumerable additional permutations such as a person or entity who invests in a non-Ponzi business owned by the Ponzi schemer. Courts seem to do better with such fact-laden determinations than they do in addressing the broad categories of investors and how to treat them when collecting and distributing funds. In any event, the three categories laid out in the text are sufficient for our purposes in this article.

Complicating these categories, we note that the funds may have been provided by the investor to the Ponzi scheme recently or years before discovery. Similarly, proceeds from the Ponzi scheme may have been received by the investor at any point, continuously or not.

We have attempted to avoid terms such as interest, profits, dividends, or return of principal when describing proceeds received from the Ponzi schemer as these, in most cases, are simply fictitious labels applied to the delivery of proceeds which originated from new funds into the scheme from new or old investors. This seems unnecessarily difficult, since many of the cases and briefs use these terms. Perhaps, just recognize that such terms are essentially a misnomer since all funds are the same. In part because of the characterizations of investors and payments both into and out of the Ponzi scheme, there is potential in Ponzi scheme cases for tremendous differences in the overall fairness of treatment of individual investors depending on a variety of factors including receipt and amount of proceeds, timing, date of discovery, the aggressiveness of the receiver or trustee and the practical problems of collection or "claw back" of proceeds from investors which are present in almost all Ponzi cases. The remainder of this article reviews several major Ponzi cases in light of overall fairness.

III. Recent Approaches to Victim Priority in Ponzi Scheme Cases

Three recent cases, *SEC v. Forte*,[26] *Janvey v. Adams*[27] and *In re Bernard L. Madoff Investment Securities LLC*[28], reflect variations of the victim fairness issue depending on the facts and procedural posture of each case. But they all contain significant discussions of how – and how not to – treat the categories of Ponzi investors fairly.

A. The *Forte* Litigation

A critical fairness issue for investors was highlighted in December 2009, in *SEC v. Forte*.[29] The Ponzi scheme in *Forte* involved the sale of limited partnerships in Joseph Forte L.P., which ultimately amassed $154 million.[30] The SEC and Commodity Futures Trading Commission ("CFTC") opposed the receiver's proposed recovery of both "profit" and "principal" from investors who received funds in excess of the amounts they

26. Nos. 09-63, 09-64, 2009 WL 4809804 (E.D. Pa. Dec. 15, 2009).
27. 588 F.3d 831 (5th Cir. 2009).
28. SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Mar. 1, 2010).
29. Nos. 09-63, 09-64, 2009 WL 4809804 (E.D. Pa. Dec. 15, 2009).
30. *Id*. at *1-2.

invested in the scheme.[31] Instead, a purported "nationwide policy", adopted by the agencies, supported claw backs of the excess amount only.[32] To recover "principal" from such investors would require "individualized evidence that they were on inquiry notice with respect to the operations of the [Ponzi scheme]."[33] U.S. District Judge Paul Diamond criticized the SEC and CFTC positions as "extraordinarily unfair."[34] Judge Diamond observed that "[a]lthough the position of the SEC and CFTC does not have clear legal support and denies Forte's victims a possible avenue of recovery, I will nonetheless reluctantly approve the Consent Orders."[35] Judge Diamond did so because he did not want to jeopardize settlement that had been reached with certain investors; however, he was clearly dismayed to do so:

> In imposing this "*mens rea*" requirement, the SEC and the CFTC have effectively limited the Receiver's recovery of principal to those winning investors who shared Joseph Forte's criminal intent. Because the winning investors' returned principal is actually the losing investors' money, those losing investors could well view the position of the SEC and the CFTC as extraordinarily unfair.[36]

Under a settlement agreement with several investors, who had received proceeds in excess of the amount paid into the scheme, the settling investors were to disgorge only the proceeds received from the Ponzi scheme over the amount they invested while keeping other proceeds they received from the scheme, up to the amount invested.[37] Judge Diamond made it clear he would likely render a different ruling in the case under different circumstances."[38]

Judge Diamond's straightforward premise for taking this approach is that "Ponzi schemes are pernicious because they masquerade as legitimate investments. In fact, only a very few early 'investors' recover their principal and earn profit – paid entirely from the monies provided by later 'investors' who commonly lose everything."[39] Judge Diamond saw that *any* monetary return to a Ponzi scheme investor is a return of tainted money.[40] His view suggests that fundamental fairness may require that consideration be given to clawing back proceeds returned to the investor (up to the

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31. *Id.* at *3.
32. *Id.* at *5.
33. *Id.*
34. *Id.*
35. *Id.* at *1.
36. *Id.* at *5.
37. *Id.* at *3.
38. *Id.* at *6 ("I do not address, however, whether the same result would obtain if I were asked to approve a similar settlement with a winning Forte investor who received a greater return of principal than [the investors here].").
39. *Id.* at *1.
40. *Id.* at *6 ("[I]t could well be more equitable and legally supportable . . . to recover . . . both the profits *and* the principal.").

amount invested) for distribution on some fair basis to other investors who have received back proceeds less than the amount they invested or nothing at all.

B. The *Stanford* Litigation

1. *The Receiver's Position*

The Stanford litigation provides further insight into conflicts between investors in Ponzi schemes. In *Janvey v. Adams*,[41] the Receiver appointed by the SEC adopted an aggressive stand on claw back issues,[42] despite resistance from the SEC.[43] Janvey filed several court motions attempting to claw back from investors not only returns that were above the principal amounts invested in the Ponzi scheme ("profits"), but also the principal amounts that the investors had recouped prior to the scheme crashing down.[44] The Receiver believed that this was the only equitable way to treat victims whose only mistake was not redeeming their money from the fund before it crashed.[45] Janvey expressed the view that there is a duty, as Receiver, to attempt to maximize the distribution pool for all of the victims of the scheme in order to make them as whole as possible.[46]

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41. 588 F.3d 831 (5th Cir. 2009).

42. Brief of Appellant Ralph S. Janvey at 11-13, Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009) (No. 09-10761) [hereinafter Janvey Brief], *available at* http://www.stanfordfinancialreceivership.com/documents/Brief_of_Receiver_in_Ralph_S_Janvey_v_James_R_Alguire_et_al.pdf. "[A]n investor who cashed out one week before the receivership should recover the same percentage of his investment as an investor who attempted to cash out one week after the receivership." *Id.* at ix. His approach was similar to that suggested by Judge Diamond in *Forte*. *See supra* notes 39-40 and accompanying text.

43. Brief of Securities and Exchange Commission, Amicus Curiae, in Support of Appellees, Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009) (No. 09-10761) [hereinafter SEC Amicus Brief], *available at* http://www.stanfordfinancialreceivership.com/documents/SEC_Amicus_brief.pdf.

44. *E.g.*, Receiver's Amended Complaint Naming Relief Defendants ¶ 48, Janvey v. Alguire, 03:09-CV-0724-N (N.D. Tex. July 28, 2009), *available at* http://www.stanfordfinancialreceivership.com/documents/014_20090728_Recs_Amended_Complaint_Naming_Relief_Defendants.pdf.

45. Janvey Brief, *supra* note 42, at 11 ("[T]here is nothing equitable about a rule that favors a few hundred Ponzi scheme investors who cashed out before court intervention over 20,000 others who did not.").

46. Receiver's Amended Complaint Naming Relief Defendants, *supra* note 44, ¶¶ 1, 44.

2. *The SEC's Position*

Janvey's approach has been met with opposition from the SEC,[47] the District Court,[48] as well as from investors who may have to return proceeds paid to them throughout the life of the scheme.[49] The SEC asserted that the Receiver does not stand in the shoes of all the "innocent investors" or the SEC, and therefore, cannot bring suit on behalf of those individuals.[50] The SEC contended these "innocent investor" defendants have a legitimate claim to the amounts representing the return of their principal investment, since each of the investors received payments in good faith and for reasonably equivalent value.[51] The SEC argued that (1) the Receiver's suit in equity was simply an attempt to circumvent the fraudulent transfer rules which make it difficult to recover the proceeds received in good faith by investors as principal and (2) no case law would allow for the pro rata distribution of receivership assets of a Ponzi scheme when the monies are in the hands of third parties and not already assembled into the receivership estate.[52]

Lastly, the SEC argued that it would be inequitable to pursue disgorgement of principal payments from a select few investors when there are hundreds – maybe even thousands – of investors who have received principal payments yet are not being sued or are beyond the court's jurisdiction.[53] Implicit in the SEC position is the concept that to achieve equity and equal treatment, the Receiver would logically need to sue every investor and seek recovery of all Ponzi proceeds received by the investor so that the receiver's fund could then be disbursed to all investors in pro rata shares. The Court agreed with the SEC position in finding "as a matter of law that innocent investors in this case who redeemed their investments before the Receivership are not liable for return of principal."[54] The Court's decision focused on the "relief defendant" theory asserted by the Receiver

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47. *See generally,* SEC Amicus Brief, *supra* note 43.

48. Order Granting in Part and Denying in Part Receiver's Motion for Order Freezing Assets Held in the Names of Certain Relief Defendants, Janvey v. Alguire, 03:09-CV-0724-N (N.D. Tex. 2009) [hereinafter District Court Order], *available at* http://www.stanfordfinancialreceivership.com/documents/doc_35_ORDER_granting_in_part_and_denying_in_part_17_MTN_for_Order_Freezing_and_for_Disgorgement_of_Assets_Held_in_the_Names_of_Certain_Relief_Defendants_Case_724.PDF.

49. *E.g.,* Response and Cross-Appeal of Gaines D. Adams, et al., Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009) (09-10761), *available at* http://www.stanfordfinancialreceivership.com/documents/Brief_of_Appellee_Cross-Appellant_Gaines_D_Adams_et_al_in_Ralph_S_Janvey_v_James_R_Alguire_et_al.pdf.

50. SEC Amicus Brief, *supra* note 43, at 20-21.

51. *Id.* at 10.

52. *Id.* at 10-11.

53. *Id.* at 11-12.

54. District Court Order, *supra* note 48, ¶ 2.

against investors and allowed the Receiver an opportunity to appeal the ruling.[55]

Under the SEC approach confirmed by the Court, an investor who cashes out in good faith before the Ponzi scheme crashes is an "innocent investor" and keeps the proceeds obtained in the cash out, up to the amount invested. Unfortunately, this approach throws most of the loss on other "innocent" investors who did not cash out at all or received proceeds less than the amount invested. These "innocent" investors seem to be the most harmed. On December 7, 2009, in an attempt to avoid the relief defendant opinion, the Receiver filed an amended complaint against investors who received proceeds asserting new theories of recovery including fraudulent transfer and unjust enrichment.[56]

3. *The Role of SIPC*

Another problem facing the Stanford investors is the lack of insurance support from either the Federal Deposit Insurance Corporation ("FDIC") or the Securities Investor Protection Act ("SIPA"). The FDIC protects against losses in value of deposits when a member bank fails.[57] However, there is no FDIC coverage in the Stanford litigation since the Stanford International Bank, which was chartered in Antigua, was not a U.S. bank and thus not a member of the FDIC.

As for SIPA coverage, the Stanford investors will be similarly left out. SIPA is essentially a securities industry insurance policy that most broker-dealers receive automatically when they register with the SEC under section 15(b) of the Securities Exchange Act of 1934.[58] In adopting SIPA, Congress created the Securities Investor Protection Corporation (SIPC)[59] and established procedures for liquidating financially troubled broker-dealers that are members of SIPC.[60] Congress' goals in enacting SIPA were to prevent failure of brokerage houses, "restore investor confidence in the capital markets" after a period of business contraction, and "upgrade the

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55. *Id.* ¶¶ 2, 6.

56. Receiver's First Amended Complaint Against Certain Stanford Investors ¶¶ 32-42, Janvey v. Alguire, 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009), *available at* http://www.stanfordfinancialreceivership.com/documents/Receivers_First_Amended_Complaint_Against_Certain_Stanford_Investors.pdf.

57. FDIC: Who is the FDIC?, http://www.fdic.gov/about/learn/symbol/index.html (last visited Mar. 28, 2010).

58. *See* SIPC v. Barbour, 421 U.S. 412, 415-16 (1975) (citing 15 U.S.C. § 78ccc (2000)); McKenny v. McGraw (*In re* Bell & Beckwith) 937 F.2d 1104, 1106 (6th Cir. 1991) (citing same).

59. 15 U.S.C. § 78ccc(a)(1) (2000); *Barbour*, 421 U.S. at 415-16.

60. *Barbour*, 421 U.S. at 416.

financial responsibility requirements for registered brokers and dealers."[61] Under section 78ddd of SIPA, the SIPC fund was created to protect the customers of SIPC member broker-dealers from loss in case of the financial failure of a SIPC member brokerage house.[62] Thus, under SIPA, recoveries to customers are accelerated and supplemented by having SIPC advance funds to the trustee to distribute to those customers up to the lesser of their Net Equity claims or the dollar amounts set out in the act.[63] Under the Act, "SIPC does not cover individuals who are sold worthless stocks and other securities"; however, SIPC will step in and aid "individuals whose money, stocks and other securities are stolen by a broker or [are] put at risk when a brokerage fails."[64]

It is the SEC's obligation to investigate instances of fraud in the broker-dealer context and to inform SIPC if they are required to get involved.[65] In the Stanford case, SIPC will not take action in fronting money to the investors because the CDs that were purchased by the investors are still in existence and are not missing.[66]

> SIPC protects the custody function performed by SIPC member firms for customers. As the facts demonstrate, when SGC [(Stanford Group Company)] . . . took cash for the purpose of purchasing CDs, that cash was sent to SIBL[(Stanford International Bank LTD)], which is precisely what the customer intended. If physical CDs were issued to, and delivered to customers, <u>those individuals have their securities</u> – the CDs themselves.[67]

"SIPC does not protect against a decline in value of any investment . . . ."[68] This distinction will be important when we discuss the applicability of SIPC and the Madoff litigation later in this article. Thus, the Stanford investors will need to look elsewhere for relief to help them recoup their losses for their "devalued" CD investments.

4. *IRS Relief*

One possible avenue that may be of some help to Ponzi investors is the Internal Revenue Service ("IRS"), which in March of 2009 amended the

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61. *Id.* at 415.
62. *See McKenny*, 937 F.2d at 1106 (citing 15 U.S.C. § 78ddd(c) (1982)).
63. *Id.* at 1106-07.
64. SICP, HOW SIPC PROTECTS YOU: UNDERSTANDING THE SECURITIES INVESTOR PROTECTION CORPORATION (2009), *available at* http://www.sipc.org/pdf/SIPC%20English %202009.pdf.
65. 15 U.S.C. § 78eee(a)(1) (2006).
66. Letter from Stephen P. Harbeck, President, SIPC, to Ralph S. Janvey, Receiver, Stanford Financial Group Receivership 3 (Aug. 14, 2009), *available at* http://www.stanfordfinancialreceivership.com/documents/SIPC_Letter.pdf.
67. *Id.*
68. *Id.* at 1.

tax treatment to allow a new deduction for losses as a result of fraudulent investments.[69] According to the amendment, investment losses, incurred because of arrangements involving criminal fraud, will be classified as theft losses and not capped at $3,000 annual as capital losses.[70] This new law will allow for greater deductions for losses in cases like the Stanford case. As a result, some Stanford victims will be allowed to deduct as much as 95% on their loss.[71]

C. The *Madoff* Litigation

The litigation in *In re Bernard L. Madoff Investment Securities LLC*[72] provides additional insight on the investor fairness issue. The fairness issue arises in the context of what measure of loss is to be used for determining the level of SIPC coverage and recovery. Briefing by the parties provides a vehicle for addressing the fairness of the Trustee's position and the alternative positions offered by objectors. According to the claims procedure approved by the court, the investors in Madoff submitted their claims of loss.[73] The Madoff Trustee then calculated the amount of approved claims based on a "cash in/cash out" method under which the customer's Net Equity[74] (from which the level of SIPC advances is established) is determined "by crediting the amount of cash deposited by the customer into his BLMIS [(Bernard L. Madoff Investment Securities LLC)] customer account, less any amounts already withdrawn by him from his

69. Rev. Rul. 2009-9, 2009-14 I.R.B. 735, *available at* http://www.irs.gov/pub/irs-irbs/irb09-14.pdf; *see also* 26 C.F.R. § 1.165-8 (2010).

70. Rev. Rul. 2009-9, 2009-14 I.R.B. 738.

71. *See* 26 C.F.R. § 601.105.

72. SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Mar. 1, 2010).

73. Trustee's Second Interim Report for the Period Ending October 31, 2009 at 26-29, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Nov. 23, 2009), *available at* http://www.madofftrustee.com/CourtFilings.aspx (search "1011" under "Docket #") (last visited Mar. 10, 2010).

74. "Where a customer has a valid Net Equity claim, and the customer's claim cannot be immediately satisfied from the fund of customer property, SIPC's funds are used, within the limits of protection, to supplement the fund of customer property and hasten the delivery of that property to customers." Memorandum of Law in Support of Trustee's Motion for an Order Upholding Trustee's Determination Denying "Customer" Claims for Amounts Listed on Last Customer Statement, Affirming Trustee's Determination of Net Equity, and Expunging Those Objections with Respect to the Determinations Relating to Net Equity at 25, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Oct. 16, 2009) [hereinafter Trustee's Memorandum], *available at* http://www.madofftrustee.com/CourtFilings.aspx (search "525" under "Docket #") (last visited Mar. 10, 2010).

BLMIS customer account."[75] This issue was before the Court because "[c]ertain claimants have objected to the Trustee's calculation of their Net Equity under SIPA, asserting that it should be exclusively calculated based upon the amounts listed on their last customer statements from BLMIS."[76]

1. *The Trustee's Position*

The Trustee's position is succinctly summarized:

> Because no securities were purchased, and no profits obtained, the customers that benefited the most from the last customer statement approach were those that were in the Ponzi scheme for the maximum amount of time, which allowed their fictitious profits to accrue year after year. Thus, the claims of earlier customers are largely made up of fictitious profits. The claims of later customers are largely for their real dollars. To allow customers' Net Equity claims in the amounts listed on their last BLMIS customer statement is to legitimize and perpetuate a fiction – that the securities and "profits" listed on their customer statements were purchased and achieved.[77]

2. *SIPC's Position*

SIPC filed a brief in full support of the Trustee's position, stating:

> If as the claimants seek, the Trustee and SIPC rely upon the last account statement, they will give credence to the backdated trades and phony profits that were invented by Madoff and carried out by Madoff and BLMIS in blatant violation of the securities laws. While a central goal of SIPA is protection of the individual customer, the protection cannot be administered at the expense of undermining the securities laws. . . . Unless the fictitious trades in BLMIS are avoided, claimants who were advantaged by the broker's fraud, that is, investors who received withdrawals from BLMIS that actually consisted of other investors' money under the guise of investment profits – including those innocent investors who received large sums of other investors' money over and above the amounts that they put into the scheme – will be allowed to benefit at the expense of other equally innocent investors.[78]

For these reasons, SIPC concluded that "returning to the customer the amount deposited by him less amounts already withdrawn by him is the correct result."[79]

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75. *Id.* at 1.
76. *Id.* (footnote omitted).
77. *Id.* at 3.
78. Memorandum of Law of the Securities Investor Protection Corporation in Support of Trustee's Motion for an Order Upholding Trustee's Determination Denying "Customer" Claims for Amounts Listed on Last Statement, Affirming Trustee's Determination of Net Equity, and Expunging Those Objections with Respect to the Determinations Relating to Net Equity at 25-26, 36, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Oct. 16, 2009), *available at* http://www.madofftrustee.com/CourtFilings .aspx (search "519" under "Docket #") (last visited Mar. 10, 2010).
79. *Id.* at 39.

3. *The Objectors' Position*

The position of the Madoff Trustee and SIPC was, not surprisingly, objected to by certain Madoff investors, likely those with large balances on their recent customer statements. One of the first to file an opposing brief was the Dean of the Massachusetts School of Law, Lawrence R. Velvel.[80] The thrust of his argument was that the Congressional purpose in enacting SIPA was thwarted by the Trustee and SIPC.[81] Dean Velvel invoked a dramatic rationale for his position:

> [*N*]*o* investor with a broker-dealer can be certain that his investment is not part of a Ponzi scheme. After all, one cannot know that one has invested in a Ponzi scheme until *after* it is revealed. So no investor will be able to withdraw earnings from his investment with confidence that he will not later be told that the withdrawn monies never existed, that the withdrawals diminish his net equity, possibly making it a negative number, that he will lose SIPC protection if it *is* a negative number, that he will also lose claims against customer property and the estate, and that he is subject to clawbacks.[82]

Dean Velvel excepted from his public policy rationale "people who were part of Madoff's conspiratorial group . . . [who] knew or plainly should have known that something *had* to be wrong."[83] Rather, he writes, "[w]e are discussing here *innocent* persons who believed the statements of account that were sent to them and had no inkling of a fraud, just as one believes in the reality of statements of account sent him by a bank and has no inkling that the bank may be committing fraud."[84] In his view, Dean Velvel's position is made financially possible by the fact that the SIPA advance payments come "*from SIPC's own funds*; the payments do not deplete the customer property or the bankruptcy estate."[85]

Dean Velvel criticized the Trustee and SIPC roundly and in a fashion that puts fairness in the spotlight:

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80. Memorandum of Objector, Lawrence R. Velvel, in Opposition to the Position of the Trustee and SIPC on Net Equity, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Nov. 10, 2009) [hereinafter Velvel Memorandum], *available at* http://www.madofftrustee.com/CourtFilings.aspx (search "685" under "Docket #") (last visited Mar. 10, 2010). Lawrence R. Velvel graduated the University of Michigan in 1960, and the University of Michigan Law School in 1963. He has served as a law professor at the University of Kansas and Catholic University and is currently the Dean of the Massachusetts School of Law. Faculty – Academic Programs, http://www.mslaw.edu/Faculty_velvel.htm (last visited Mar. 10, 2010).

81. Velvel Memorandum, *supra* note 80, at 1.

82. *Id.*

83. *Id.* at 7.

84. *Id.* (footnote omitted).

85. *Id.* at 9.

> In order to disregard Congress' desire to *protect* investors, not harm them, SIPC and the Trustee have fastened on a single idea which, *they* say, is the sole criterion of equality and therefore *must* be followed despite Congress' protective intent. The sole measure of equality, *they* say, is that regardless of the November 30th statements, one gets back only what she put in on a net basis, so that if an innocent person took out more over the years than she put in, did so in the best of faith and in the honest and legitimate belief that she had what her statements showed, conducted her economic life on the basis of the statements she received, and is now rendered hopelessly impoverished by the Trustee's method of calculating net equity, still she gets nothing because a positive net amount on a cash basis is the only possible criterion of equity and the only possible measure of equality.[86]

The "icing on this cake," as Dean Velvel put it, is that many of the withdrawals over the years were taken to pay "billions of dollars in taxes on phony profits."[87]

Dean Velvel's brief expresses the extreme emotions evoked by the aftermath of a Ponzi scheme. Dean Velvel relies on briefs filed by others in *Madoff* to present the case law and statutory authorities in support of the objectors' general position that the amount on the last statement determines the amount to be received by customers.[88] Primarily, such briefs rely on 15 U.S.C. § 78lll(11) which provides that:

> The term 'net equity' means the dollar amount of the account or accounts of a customer, to be determined by –
>
> (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer (other than customer name securities reclaimed by such customer); minus
>
> (B) any indebtedness of such customer to the debtor on the filing date . . .[89]

It is true that an investor who receives proceeds, all of which are used to pay taxes on phantom profits, is seriously harmed. Conversely, those who received proceeds in excess of taxes do have a benefit as contrasted with those who provided funds to the Ponzi scheme and have received very little or no proceeds back. This circumstance exemplifies the fairness issues.

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86. *Id.* at 11.
87. *Id.* at 11-12.
88. *Id.* at 3.
89. 15 U.S.C. § 78lll(11)(A)-(B) (2000); *see, e.g.*, Reply Memorandum of Law in Opposition to Trustee's Motion for an Order Upholding Trustee's Determination Denying Customer Claims' [sic] for Amounts Listed on Last Statement, Affirming Trustee's Determination of Net Equity, Expunging Those Objections with Respect to the Determinations Relating to Net Equity at 6-7, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Dec. 21, 2009) [hereinafter Lax & Neville Memorandum], *available at* http://www.madofftrustee.com/CourtFilings.aspx (search "1105" under "Docket #") (last visited Mar. 10, 2010).

4. *The Trustee's Rejoinder*

The Trustee's response is that the objectors typically ignore or gloss over the provision in 15 U.S.C. § 78fff-2(b) which provides:

> After receipt of a written statement of claim . . . , the trustee shall promptly discharge . . . all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by delivery of securities or the making of payments to or for the account of such customer . . . *insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee.*[90]

Based on this section of SIPA, the Trustee argues:

> Numerous customers have pointed to the last fictitious BLMIS customer statement as the only source of "books and records" to support their claims. While the BLMIS statements and confirmations received by customers may be construed as part of the debtor's "books and records," the books and records of BLMIS in fact comprise many more sources of information that reflect the actual financial transactions that occurred and that negate the accuracy of the BLMIS customer statements. Relevant books and records include financial records including bank records, annual reports, the [Depository Trust and Clearing Corporation] account information, other corporate documents, and customer-related files such as account maintenance folders. . . . Notably, these "books and records" other than the customer statements indicate that trades were not made on behalf of customers or actually paid for by the customers or a reflection of genuine market activity or pricing.[91]

The Sonnenschein Investors take issue with the Trustee on this point:

> Although the provision [15 U.S.C. § 78fff-(2)(b)] is not a model of clarity, it is not on its face an invitation to test the validity of every transaction in a customer account. First, the provision gives the Trustee discretion to stop his investigation at the point of the statement, which lists the securities and their market value purportedly in the account. Moreover, the provision can be read, without the violence done to it by the Trustee and SIPC, to direct the trustee to the books and record[s], if necessary, to determine if a claim is for cash or securities. Based on the statute, the legislative history and the case law, it does not matter if "the statements indicate trades that were not made on behalf of the customers or actually paid for by the customer." See Trustee Memorandum at page 27. Accordingly, the Trustee has misused this provision for an expensive and time consuming reconstruction of each account, which has not only delayed recovery to investors, but also denied them a rightful recovery in contravention of SIPA.[92]

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90. 15 U.S.C. § 78fff-2(b) (1978) (emphasis added).

91. Trustee's Memorandum, *supra* note 74, at 26-27.

92. Sonnenschein Investors' Opposition to the Trustee's Motion for an Order Upholding Trustee's Determination Denying "Customer" Claims for Amounts Listed on Last Statement, Affirming Trustee's Determination of Net Equity and Expunging Those Objections with Respect to the Determination s [sic] Relating to Net Equity at 7-8, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Nov. 13, 2009), *available at* http://www.

In sum, the focus of the Madoff Net Equity briefing has been on the issue of fairness – ultimately, how the courts determine who gets what – that is the central theme of this article:

> [I]t is simply unfathomable that a person, whose life savings disappeared overnight, could be exposed to the fraudulent conveyance actions proffered by the movants. If over the course of 20 years, an individual withdrew $100,000 more than they originally invested even though their last account statement reflected a balance of $500,000, they would be liable to the Trustee for $100,000 under the Movants' proposal. This is simply mindboggling and wholly inconsistent with what Congress envisioned with the passage of the SIPA.[93]

At least, the investor described by Lax & Neville received back the amount put in plus more. Contrast this to the investor who put funds in and received nothing back. The emotional power of the arguments exceeds even the typical zealous advocacy and the impact on the Madoff investors will make the court's decision one that will be much anticipated and criticized no matter which way it turns out.

5. *Judge Lifland's Opinion*

On March 1, 2010, Judge Burton Lifland of the U.S. Bankruptcy Court for the Southern District of New York issued his opinion substantially adopting the Trustee's and SIPC's position.[94] On the central issue of how to interpret SIPA, the Court wrote:

> Contrary to the contention of many Objecting Claimants, permitting a customer to recover SIPC payments based on final account statements would in fact affect the limited amount available for distribution from the customer property fund. These Objecting Claimants rely upon the false premise that Madoff customers are statutorily entitled to an additional source of recovery in the form of SIPC *insurance*, separate and apart from customer property distributions. This argument finds no sup-

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madofftrustee.com/CourtFilings.aspx (search "784" under "Docket #") (last visited Mar. 10, 2010).

93. Memorandum of Law in Opposition to Trustee's Motion for an Order Upholding Trustee's Determination Denying Customer Claims for Amounts Listed on Last Statement, Affirming Trustee's Determination of Net Equity, and Expunging Those Objections with Respect to the Determinations Relating to Net Equity at 36, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Nov. 13, 2009), *available at* http://www.madofftrustee.com/CourtFilings.aspx (search "803" under "Docket #") (last visited Mar. 10, 2010).

94. Memorandum Decision Granting Trustee's Motion for an Order (1) Upholding Trustee's Determination Denying Customer Claims for Amounts Listed on Last Customer Statement; (2) Affirming Trustee's Determination of Net Equity; and (3) Expunging Objections to Determinations Relating to Net Equity, SIPC v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Mar. 1, 2010) [hereinafter Memorandum Decision].

> port in the text of the statute, which characterizes SIPC payments as *advances* inextricably tied to distributions of customer property.[95]

This means that "the SIPA statute does not allow bifurcation of the claims process, with customers recovering SIPC payments based on the Last Statement Method, and recovering customer property shares based on the Net Investment Method."[96]

In the Court's view, this is a just outcome in the first instance because "[t]he account statements are entirely fictitious, do not reflect actual securities positions that could be liquidated, and therefore cannot be relied upon to determine Net Equity."[97] The Court relied on the "books and records" section of SIPA[98] in concluding that the entirety of Madoff's "books and records expose a Ponzi scheme where no securities were ever ordered, paid for or acquired."[99]

More importantly, this is a just outcome because:

> Any dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested. If the Last Statement Method were adopted, Net Winners would receive more favorable treatment by profiting from the principal investments of Net Losers, yielding an inequitable result.[100]

In sum, the Court concluded:

> Equality is achieved in this case by employing the Trustee's method, which looks solely to deposits and withdrawals that in reality occurred. To the extent possible, principal will rightly be returned to Net Losers rather than unjustly rewarded to Net Winners under the guise of profits. In this way, the Net Investment Method brings the greatest number of investors closest to their positions prior to Madoff's scheme in an effort to make them whole.[101]

Though Judge Lifland's decision supports the Trustee and SIPC at every turn, the ultimate legal viability of the Net Equity approach will likely be determined at the appellate level. If nothing else, the decision makes even more compelling the need for addressing the problem of unraveling Ponzi schemes.

CONCLUSION - IS A NEW APPROACH APPROPRIATE AND NECESSARY?

Victims of a Ponzi schemes should be treated in an evenhanded and fair manner across the board. It can be reasonably argued that simply because someone cashed out before discovery of the fraud or received

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95. *Id.* at *8 (footnote omitted).
96. *Id.* at *9.
97. *Id.* at *10.
98. 15 U.S.C. § 78fff-2(b) (1978).
99. Memorandum Decision, *supra* note 94, at *10.
100. *Id.* at *14.
101. *Id.* at *15 (citation omitted).

proceeds along the way (whether called interest, dividends, or return of principal) they should not be allowed to retain such amounts to the disproportionate detriment of investors who do not cash out, receive proceeds, or received very little. The legal principles often utilized in the Ponzi scheme cases were not originally developed to address Ponzi scheme victim fairness issues and create somewhat extreme arguments and results.

Laying aside the practical challenges, which are significant, it can be argued that the fairest way to unravel a Ponzi scheme mess is the approach suggested by Judge Diamond in *Forte*.[102] It is unclear why the SEC takes the opposing position as it seems to lead to disproportionate unfairness.[103] Perhaps it is the practical difficulty of totally unwinding the Ponzi scheme distributions. If the SEC believes that the total unwind is simply too impractical, it should say so, permitting argument on that point to develop.

Given all the other Congressional action this past year,[104] we are reluctant to predict or suggest creation of a securities insurance framework (or sub-framework) tailored to Ponzi schemes which would address the need for fundamental fairness as to all investors. However, legislation could be enacted within the context of the present SIPC and Bankruptcy Code (or otherwise) that allows a court to apply equitable principles including claw backs, modification of statutes of limitation and the inapplicability of traditional common law or statutory laws that were not intended to address Ponzi schemes. Practical problems of such an approach are serious and there is no perfect resolution. However, a fundamental principle should be that all victims share the pain on an equal basis. Simply because someone has cashed out before discovery or received proceeds for years, which are traceable to other Ponzi victim investments, should not allow them to have less pain than those who have received back little or nothing from the Ponzi schemer. The current case-by-case approach does not appear to yield fair uniform results. A new comprehensive approach designed for overall victim fairness should be considered.

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102. *See supra* Part III.A.

103. *See supra* Part III.B.2.

104. *E.g.*, Jeanne Sahadi, *Stimulus: How it May Affect Your Wallet*, CNNMoney.com (Feb. 24, 2009) (detailing provisions of Congress' $787 billion stimulus package), *available at* http://money.cnn.com/2009/02/13/news/economy/stimulus_individuals/index.htm.