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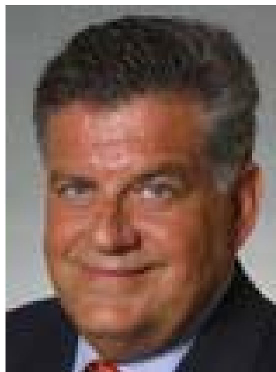
Guest Column

Why Ponzi Scheme Investors Must Return Profits

By Lewis B. Freeman (pictured), Wayne Klein and Daniel J. Stermer, Lewis B. Freeman & Partners Inc.



Law360, New York (December 30, 2008) -- Now that Bernie Madoff has admitted that he was running a $50 billion Ponzi scheme — losses greater than the amount needed to bail out the entire domestic automobile industry — two monumental tasks lie ahead for the receiver and great battles are foreshadowed between investor factions.

Receiver's Goal: Find The Money

The first step for the receiver is to figure out quickly where the money went. With as much as $50 billion in money flowing through the company over several decades, this will be a herculean task. Nevertheless, the case cannot progress without this information.

Second, the receiver must retrieve all assets that can be located, so the assets can be used to pay investors and creditors.

One of the biggest sources of assets is expected to be investors who gave money to the scheme, then decided to withdraw, taking their money and the accumulated profits on their investment.

The problem is that in the case of a Ponzi scheme, the accumulated profits were fictitious; money paid to the departing investors was more than their investments were truly worth and it came from new victims of the scam.

Payments Are Necessary To Further The Fraud

The hallmark of a Ponzi scheme is that it uses later-acquired funds to pay off previous investors. Purposefully paying investors substantially more than their investments are really worth is designed to validate the false reports of investment success (to induce new investors to send money) and to conceal the fraud from existing investors.

This conduct, however, creates intrinsic conflicts. If the withdrawing investors are actually getting

money paid by other investors, which group has the superior right to those funds: the provider of the money or its recipients? Not surprisingly, both groups think they deserve these funds.

In most cases, the law requires those who profited to return funds they received.

Modern Version Of Privateer

Privateers were common from the 16th to 19th centuries. They were private warships authorized by a country to attack and rob enemy ships during wartime.

The privateers were awarded a commission based on the value of the ships and cargo captured. The privateers were funded by investors hoping to profit from the raids. Investors profited with money taken from their enemies. In the process, their countries benefitted.

The modern version of privateers — investors wanting to keep their excess distributions — also profit at the expense of others. However, there are two important differences. The enemies from whom they are taking money are not foreign countries, but are fellow investors — victims of the same scheme. Moreover, they are not seeking these monies to help their country in war, but to keep for themselves. For this reason, we call them profiteers.

Just as governments no longer commission privateers, legislatures and courts have rejected attempts by profiteers to keep excess distributions they received from Ponzi schemes.

Fraudulent Conveyance Laws

All states have fraudulent transfer laws; over 40 of them have adopted the Uniform Fraudulent Transfer Act. Their provisions are similar to those in the federal bankruptcy laws.

Essentially, these laws state that transfers of funds from entities that were insolvent at the time or were part of the entity's efforts to "hinder, delay, or defraud creditors" are fraudulent transfers and can be recovered. A receiver (or bankruptcy trustee) appointed for the entity can file suit to recover amounts paid to others in fraudulent transfers.

Actual V. Constructive Fraud

In our experience, receivers seeking to recover payments made by the entity generally will proceed under two theories: actual fraud or constructive fraud. There are different levels of proof for each and different remedies.

Actual fraud is when the receiver can demonstrate that transfers were made "with actual intent to hinder, delay, or defraud the creditors" (such as the investors who receive nothing). When the receiver can show actual fraud, the receiver can recover all payments made to transferees (earlier investors), subject to one defense discussed below.

Constructive fraud may be shown when the receiver demonstrates that the transfer of "profits" to the winning investor was made "without receiving a reasonably equivalent value in exchange for the transfer."

In such cases, the receiver may recoup distributions to the investor that exceed the investor's capital contribution. In the case of both actual and constructive fraud, the receiver can require the transferees to pay interest on excess funds they received.

Badges Of Fraud

Since it may be difficult to prove actual intent to hinder, delay, or defraud, courts permit receivers to demonstrate intent by identifying "badges of fraud."

These badges of fraud are omnipresent in investment Ponzi schemes: profits were never earned; money was diverted for personal use; and bogus account statements were distributed (falsely claiming investment gains).

Good Faith Defense

"Good faith" and "value" may be a defense to a fraudulent transfer claim. The bankruptcy code, like fraudulent transfer statutes, provides that a transferee that takes a transfer "for value and in good faith" may retain any interest transferred to the extent that the transferee gave value to the debtor (such as an earlier investment).

Since value is generally present, the question most frequently at issue is whether the investors receiving the preferential transfers accepted them in good faith. But note that the good faith defense only protects principal; it does not permit an investor to keep funds beyond the amount of initial investment.

This defense is not automatic and might not be an easy one to prove. To start with, it is an affirmative defense; courts put the burden on the transferee to claim the defense and to establish facts to prove the defense.

As receivers, we are not required to prove that the transfer lacked good faith; it is up to the recipient of funds to prove good faith existed. Courts will permit receivers to conduct discovery to probe whether circumstances surrounding the transfer demonstrate the absence of good faith.

Good faith represents a high standard. It means more than just that the investor was not colluding in the decision to make the preferential payment. It means the investor had no knowledge of problems with the investment or suspicions about the financial viability of the investment.

In other words, the investor must show that she withdrew funds for reasons unrelated to the operation of the investment scheme.

Where Does The Retrieved Money Go?

As noted above, the receiver's role is to recover as many assets and funds for the entity as possible. When that happens, the receiver likely will recommend that the court approve a plan to distribute assets of the entity to investors — but on a pro rata basis.

In this manner, excess profits disgorged by investors will be shared among investors who received no returns of principal or profit. Investors who had to return principal distributions they were paid will get some of that money back — but on par with what other investors receive.

In the battle between investors who received distributions and those who did not, the first group must give up some or all of their profits. The receiver then can share those funds with all investors.

Conclusion

Whether the fraud is actual or constructive, the investors must return any profits they received beyond the amounts of their investments.

If actual fraud is shown, investors receiving preferential payments must return all funds they received, even including returns of their own principal investments — unless these investors demonstrate that they had no knowledge of the fraud and their withdrawals were due to reasons unrelated to the entity's problems.

More Information

Due to differences in the state and federal laws that might apply, advice should be sought from counsel with experience in securities and receivership law.

Lew Freeman is a founding principal with Miami-based national forensic accounting and consulting firm Lewis B. Freeman & Partners Inc. Wayne Klein and Daniel Stermer are principals with the firm.