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Expert Analysis

Court-Appointed Receivers For Ponzi Schemes


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On Dec. 11, 2008, the Securities and Exchange Commission charged Bernard L. Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC (BMIS), with securities fraud for a multi-billion dollar Ponzi scheme that he allegedly perpetrated on advisory clients of his firm.[1]

The next day, U.S. District Court Judge Louis Stanton granted the SEC's request for emergency relief for investors, freezing the assets of Mr. Madoff and BMIS, and appointing a receiver for the assets of BMIS, including the assets of Madoff Securities International Ltd. and Madoff Ltd. Shortly thereafter, Judge Stanton appointed a trustee under the Securities Investor Protection Act of 1970 (SIPA) for the liquidation of BMIS.

As is common with Ponzi schemes, more money was entrusted than is readily returnable and all customers want their assets back as quickly as possible. Given that economic downturns tend to reveal Ponzi schemes, because continuous investment is necessary to prevent the pyramid scheme from collapsing, Mr. Madoff's might be the largest scheme, but may not be the last to surface. This article addresses the law governing the appointment of a receiver over frozen assets and the equitable distributions of such assets to investors who were victims of a Ponzi scheme.

It is important to first understand the general contours of a Ponzi scheme because, as discussed below, the nature of such schemes plays a role in fashioning an equitable plan for the distribution of assets to the victims of such a fraud. Generally, a Ponzi scheme is "a pyramid scheme where earlier investors are paid from the investments of more recent investors, rather than from any underlying business concern, until the scheme ceases to attract new investors and the pyramid collapses."[2]

Thus, the wrongdoer creates the appearance of profitability only by virtue of "obtaining new investors and using those investments to pay for the high premiums promised to earlier investors."[3] Some purported investments are illegal Ponzi schemes from their beginnings, from the first dollar delivered by the first investor. Some legitimate businesses, on the other hand, morph into Ponzi schemes after the business suffers investment losses and the principal cannot bear to reveal the truth to his investors.

As in the Madoff case, it has become increasingly common for the SEC to request that the district court appoint a receiver to assume control over a corporation and its frozen assets where the corporation or its principals are alleged to have committed a massive fraud. While "neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 explicitly vests district courts with the power to appoint trustees or receivers, courts have consistently held that such power exists."[4]

"Receivers appointed at the SEC's request are equipped with a variety of tools to help preserve the status quo while the various transactions are unraveled to obtain an accurate picture of what transpired."[5] A district court may use its equitable authority to determine the exact scope of the receivership's powers on a case-by-case basis.[6]

Receivers are creatures of the court, and thus have no more or no less power and responsibility than are granted to the receiver in the Order Appointing Receiver. It is generally not part of the receiver's job to determine whether any particular person or entity deserves to be charged with crimes or violations of the securities laws; those are functions carried out by the U.S. Department of Justice through its U.S. Attorneys Offices, and the Securities and Exchange Commission.

A receiver does, however, generally work closely and cooperatively with the relevant law enforcement authorities. A receiver's power is derivative in nature, and thus, the receiver "may commence lawsuits, but stands in the shoes of the corporation and can assert only those claims which the corporation could have asserted."[7] The receiver may also assert or waive the corporation's attorney-client privilege.

An equity receiver may also recommend a plan for distribution of frozen assets to investors. The district court may order such a distribution using its equitable powers.[8] Such orders are immediately appealable because they modify the freeze order that the court initially entered.[9]

Pro Rata Distribution

The U.S. Court of Appeals for the Second Circuit has held that when a district court uses its equitable powers to order a distribution of assets to the victims of a Ponzi scheme, the use of a pro rata distribution is generally appropriate.[10]

In *SEC v. Credit Bancorp, Ltd.*, approximately 200 investors invested with Credit Bancorp, Ltd. (CBL) in what they were told was a "riskless arbitrage" scheme, for assured high rates of return. As part of the fraud, CBL induced customers to deposit cash or securities supposedly in trust with CBL. Instead of holding the cash or shares in trust, Credit Bancorp took control of the assets, and simply took the cash and diverted the shares into margin accounts in the name of Credit Bancorp in different brokerage firms, and drew out millions in cash in margin loans. In November 1999, the SEC filed an enforcement action and quickly obtained an asset freeze order.

The district court appointed a receiver to marshal Credit Bancorp's assets and to prepare a distribution plan. (Mr. Loewenson was appointed receiver in Credit Bancorp.)

The largest customer, which had deposited $80 million in securities, proposed a plan of distribution providing that its traceable shares would be returned to it ahead of distributions to other defrauded investors.

The SEC objected, and proposed a plan providing for the liquidation of all Credit Bancorp's assets, and ratable distribution to the investors in proportion to their losses, with the customer-deposited securities valued as of date of deposit, rather than date of the asset freeze or the date of distribution.

The receiver presented a compromise plan designed to achieve the SEC's objective that all investors benefit from the distribution on a pro rata basis (according to the amount of their investments) and also meet many customers' preference that their shares not be liquidated. Under this plan, shares could be returned to investors, but the investor would be required to pay into the receivership estate a cash "undertaking" "determined primarily from a percentage of the value of the shares (the percentage reflecting the portion of all victims' investments that were lost)."[11]

The cash undertaking would then be part of the receivership estate and could fund the pro rata distribution to those customers who had deposited cash with Credit Bancorp.

U.S. District Judge Robert W. Sweet approved the compromise plan, holding that "while a court sitting in equity may allow tracing, there is no entitlement on the part of a defrauded customer to that measure as it may 'frustrate equity.'"[12]

The district court explained that "one of the key characteristics of a Ponzi scheme is that not all assets are immediately consumed by the

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perpetrator of the scheme," but "[r]ather, some assets are retained for a period of time before being used in connection with the fraud."

Thus, he said, an investor may only trace its assets because "the defrauders spent the money of the other victims first."

Judge Sweet explained that allowing certain investors to seek restitution of specific assets would "create inequitable results, in that certain investors would recoup 100 percent of their investment while others would receive substantially less."

The judge also acknowledged the Second Circuit's admonition in *SEC v. American Board of Trade, Inc.*, that a receivership not be substituted for a bankruptcy proceeding to effectuate a liquidation of a defendant firm.[13]

In *American Board of Trade*, the Second Circuit strongly suggested that a bankruptcy court and bankruptcy trustee are better suited to handle a complete liquidation given their experience processing thousands of claims forms, setting priorities among classes of creditors, and administering the sale of real property.

In *Credit Bancorp*, the SEC took the position that the proposed partial distribution was not a complete liquidation and therefore did not run afoul of *American Board of Trade*.[14]

The customer did not want Credit Bancorp to be put in bankruptcy, because one of the first steps in bankruptcy would have been the liquidation of all the customer-deposited securities. Many of the customers had deposited restricted stock or control stock in their own companies, and many customers did not want to incur tax on capital gains that would have resulted from the liquidation of their shares.

Judge Sweet allowed the partial distribution to go forward given the SEC's position, the fact that "neither the Receiver nor, more importantly, the defrauded customers, have sought the initiation of bankruptcy proceedings," and "given that the contemplated distribution is partial in nature."

On appeal, the Second Circuit affirmed the district court's order approving the compromise plan for pro rata distribution. The Second Circuit held that "[c]ourts have favored pro rata distribution of assets where, as here, the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders."[15]

The court further noted that "the use of a pro rata distribution has been deemed especially appropriate for fraud victims of a Ponzi scheme, in which earlier investors returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity."

The panel added, "In such a scheme, whether at any given moment a particular customer's assets are traceable is a result of the merely fortuitous fact that the defrauders spent the money of the other victims first."

The Second Circuit distinguished cases permitting the return of identifiable assets to particular victims, explaining that, unlike with Credit Bancorp, the assets in such cases "had somehow been segregated in the manner of true trust accounts and/or had never been placed in the defrauder's control."

The *Credit Bancorp* decision, however, leaves open the question of whether an investor with an express trust may avoid pro rata distribution. The Second Circuit noted that had the customer-deposited shares been transferred to Credit Bancorp pursuant to an express trust, the court would have had to "confront the issue of whether the equitable interests of the settlor of an inter vivos trust may be adjusted by a pro rata distribution ordered by a district court, exercising its equitable jurisdiction in an SEC-initiated receivership proceeding, to remedy fraud perpetrated upon the settlor and other victims."[16]

But the court concluded that this was neither a case where "shares [were] transferred under an express trust" nor "a case where a party is fraudulently deceived into signing transfer papers that it was entitled to believe would have accomplished a transfer under an express trust."

The Second Circuit further held that while, under New York law, "assets acquired by fraud are subject to a constructive trust for the benefit of the defrauded party," the defrauded customers' beneficial interest arising from the constructive trust "does not defeat the equitable authority of the District Court to treat all the fraud victims alike (in proportion to their investments) and order a pro rata distribution."

Federal courts of appeals in other circuits have also acknowledged that a pro rata distribution of assets to the victims of a Ponzi scheme is generally appropriate when there are not enough funds to go around.[17] The courts have focused on ensuring that receivership distributions treat the innocent victims of such schemes equally. Of course, the devil is in the details of what is fair and equitable, given the nearly infinite variety of investment schemes, legal and illegal. Even where tracing of a victim's investment is possible, district courts may exercise their equitable powers to approve a receiver's pro rata distribution plan.

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SIPA Trustee

In order to protect investors against losses arising from the insolvency of their brokers, a district court may also appoint a SIPA trustee (as in the Madoff case). Following the entry of a SIPA protective order and appointment of a SIPA trustee, the court must remove the liquidation proceeding to the bankruptcy court, and the proceeding is then conducted in accordance with relevant provisions of the Bankruptcy Code to the extent that such provisions do not conflict with SIPA.

Under SIPA, those who qualify as "customers" of the brokerage are given priority over other unsecured creditors in the distribution of the broker-dealer's customer-related property. Each customer is entitled to receive all of that customer's "customer name securities," which are securities registered in the customer's name that are not transferable by the broker-dealer, and a ratable share of all of the customers' "customer property," which is generally all property the broker-dealer held that was, or should have been, set aside for customers.[18] "If the fund of customer property is insufficient to make the customers whole, the government makes up the difference—subject to a cap—out of a special SIPC fund capitalized by the general brokerage community."[19]

The use of a SIPA trustee, however, is not necessarily exclusive of an equity receivership. For example, in the case of a massive fraud, a district court may order a SIPA liquidation for an insolvent brokerage, but place other entities' or individuals' assets in receivership.[20]

Conclusion

The receivership process has the potential to provide pragmatic and equitable solutions to victims of Ponzi schemes. While the Second Circuit has suggested that any complete liquidation of an insolvent firm that was the vehicle for a Ponzi scheme should be carried out in a bankruptcy, liquidation of securities may not always be in the best interests of certain customers who had invested assets in the scheme.[21]

Despite the Second Circuit's admonition, courts have approved a receivership's partial distribution of assets following a Ponzi scheme. Moreover, in cases in which there are a more manageable number of customer claims and where the principal assets in the receivership are securities, a receiver's distribution of assets may be less likely to run afoul of the concerns express by the Second Circuit in *American Board of Trade*.

1. *SEC v. Madoff et al.*, 08 Civ. 10791 (LLS) (S.D.N.Y.).
2. *Eberhard v. Marcu*, 530 F.3d 122, 132 n. 7 (2d Cir. 2008).
3. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1088 n.3 (2d Cir. 1995).
4. *Eberhard*, 530 F.3d at 131 (internal quotations omitted).
5. *Eberhard*, 530 F.3d at 131 (internal quotations omitted).
6. See *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1105 (2d Cir. 1972).
7. *Eberhard*, 530 F.3d at 132.
8. See *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002).
9. 28 U.S.C. § 1292 (a)(1); *Credit Bancorp*, 290 F.3d at 86-87.
10. *Credit Bancorp*, 290 F.3d at 89.
11. *Credit Bancorp*, 290 F.3d at 85-86.
12. *SEC v. Credit Bancorp, Ltd.*, 99 Civ. 11395 (RWS), 2000 U.S. Dist. LEXIS 17171 at *45 (S.D.N.Y. Nov. 29, 2000).
13. *SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431, 436-37 (2d Cir. 1987) ("receiverships ancillary to SEC actions against brokers or broker-dealers should not be continued, in a case involving insolvency, beyond the point necessary to get the estate into the proper forum for liquidation – the bankruptcy court."); see also Eberhard, 530 F.3d at 132.
14. *Credit Bancorp*, 2000 U.S. Dist. LEXIS 17171 at *89.
15. *Credit Bancorp*, 290 F.3d at 88-89.
16. *Credit Bancorp*, 290 F.3d at 87.
17. *SEC v. Infinity Group Co.*, 226 Fed.Appx. 217, 218-219 (3d Cir. 2007); *SEC v. Forex Asset Mgmt. LLC*, 242 F.3d 325, 331-32 (5th Cir. 2001); *U.S. v. Durham*, 86 F.3d 70, 72-73 (5th Cir.1996); *U.S. v. Real Property Located at 13328 and 13324 St. Hwy N.*, 89 F.3d 551, 553-54 (9th Cir. 1996); *U.S. v. Vanguard Inv. Co., Inc.*, 6 F.3d 222, 226-27 (4th Cir. 1993); *SEC v. Elliott*, 953 F.2d 1560, 1569-70 (11th Cir. 1992).
18. 15 U.S.C. §§ 78fff-2(b) to (c), 78lll(3) to (4); *In re New Times Secs. Svcs., Inc.*, 463 F.3d 125, 127 (2d Cir. 2006).
19. *New Times*, 463 F.3d at 127.
20. See, e.g., *Eberhard*, 530 F.3d at 126-27.
21. See 11 U.S.C. §§ 741-752.