March 28, 2011

Allocating Loss in Securities Fraud: Time To Adopt A Uniform Rule For The Special Case of Ponzi Schemes

Grant Christensen
ALLOCATING LOSS IN SECURITIES FRAUD: TIME TO ADOPT A UNIFORM RULE FOR THE SPECIAL CASE OF PONZI SCHEMES
By: Grant Christensen*

ABSTRACT: The Global Financial Crisis precipitated a condensing of capital and a fall in global equities markets that resulted not solely in the necessity of government bailouts of the financial industry but also exposed a number of Ponzi schemes that collectively will cost investors tens of billions of dollars. With a new wave of litigation by innocent investors against Ponzi scheme operators just beginning, and likely to take years, it becomes important to clearly identify the methodologies used to value the loss and allocate existing assets among remaining creditors. To that end I offer this article to argue that courts ought to use a comparatively new approach – the loss to the losing victim methodology originally pioneered in criminal law – to determine how equally innocent victims share the losses these schemes precipitated. By standardizing the calculation of loss to investors in both criminal and civil law, the courts will not only make the determination of loss considerably easier, but also more equitable.

I. Introduction
II. Courts Have Discretion to Determine Evaluation
III. Secured v. Unsecured Creditors
IV. The Major Approaches
   A. Net Investment Approach
   B. Rescission and Restitution
   C. Loss to the Losing Victim
V: Equitable Valuation: The Special Case of Ponzi Schemes
VI: Conclusion

* Grant Christensen is currently a lecturer in law at the University of Toledo College of Law and will be a visiting professor of law at the University of Oregon beginning August 2011. He is a graduate of the Ohio State University Moritz College of Law and has an L.L.M. from the University of Arizona James E. Rogers College of Law. I would like to thank Vaughn Hoblet for first introducing me to the question of party valuation in Ponzi Schemes and for his helpful comments and suggestions through the writing process.

I. Introduction

The impetus of the Global Financial Crisis resulted in the revelation that many of the world’s most revered financial institutions were not as well secured as investors were led to believe.¹ In addition to sparking the government bailout of banks, insurances companies, and the

auto-industry, the devaluation of equities resulted in the discovery of a number of major Ponzi schemes that collectively will have cost investors tens of billions of dollars including the Bayou Group LLC, the Tom Petters scheme, Dreier LLP, and the now infamous Bernie Madoff scandal. Courts are just starting to come to grips with dismantling the shell companies, fictitious accounts, illusory insurance policies, and questionable operations upon which these schemes relied, attempting to return whatever possible to the innocent investors.

This process will invariably produce new regulation intended to uncover such fraudulent schemes, beginning with the Dodd-Frank Wall Street Reform and Consumer Protection Act and the promulgation of new rules by regulators, both national and international, designed to improve the transparency of the global financial system. Other proposals go even further. While the

---


3 The term “Ponzi Scheme” was first coined in the 1920s after Charles Ponzi – an Italian immigrant living in Boston – went from obscure salesman with $150 in capital to a multi-millionaire in less than six months by claiming to trade in international postal coupons and promising returns of 100% interest. The subsequent collapse of his fraud, resulting eventually in his bankruptcy, captivated the imagination of the country. Peter S. Kim, Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense 2008 Columbia. Bus. L. Rev. 657, n.68 (2008) see also Cunningham v. Brown, 265 U.S. 1, 7-9 (1924) (Holding that preferential payments after the discovery of fraud from Ponzi’s postal scheme were recoverable by other creditors).


6 U.S. v. Mark Dreier 09 Cr. 085 (JSR) (S.D.N.Y., March 22, 2010) (Criminal case), In re Dreier LLP 429 B.R. 112 (2010) (Civil suit by creditors against Dreier’s bankrupt estate). The total loss was approximately $30 million.


8 P.L. 111-203, H.B. 4173 (111th Congress)

court battles over the remaining assets, which by the very nature of the fraud are substantially smaller than the principle creditors extended to the schemes, will further standardize the accounting, allocation, and distribution of the remaining assets of a Ponzi scheme – there remains an open question of how the billions of dollars of lost value can be allocated among those creditors who are entitled to it. Should all investors bear the costs of fraud equally? Ought those with security interests be better protected by the courts and take first among the remaining assets? What if the remaining assets amount to less than even the secured interests? Because a Ponzi scheme relies on a constant inflow of funds to perpetuate the fraud, should those who were induced to invest first be compensated differently from those who invested last? What about the opportunity of a party to discover the fraud? These open questions will be teased out and litigated in state and federal courts for the better part of the next decade. Courts will inevitably come to different conclusions requiring appellate clarification, and assuming an ultimate split among the circuits,  final determination by the Supreme Court itself.

To that end I offer this article to lay out the various methods of determining the recoverable loss of each party and argue that the most equitable solution is grounded on principles founded in civil law, but developed in the criminal prosecution of Ponzi scheme operators. Known alternately as the rescission and restitution method, or the loss to the losing victim method, this principle of allocating loss accurately compensates all parties for the actual

10 H.R. 5032 (111th Congress) Ponzi Scheme Investors Protection Act of 2010
11 A split is already emerging between the use of the net-investment approach favored by the 2nd Circuit, the rescission and restitution method popularized by the 9th Circuit, and the Loss to the Losing Victim Method promulgated by the 8th Circuit. Each is defined and evaluated in Part IV of this article.
12 AFI Holding Inc., v. Mackenzie, 525 F.3d 700 (9th Cir., 2008) (“the investors were duped into buying modules, and because of that, they had claims for rescission and restitution which arose at the time of purchase”) (citing In re: United Energy Corp., 944 F.32 589 (9th Cir., 1991), Jobin v. McKay (In re M & L Bus. Machine Company), 84 F.3d 1330 (10th Cir., 1996) (“investors in a fraudulent scheme "clearly had claims for rescission and restitution . . . regardless of whether there existed a contractual right to the return of principal").
13 The proper focus is on the amount of loss for a particular victim. United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996) (holding that, in calculating loss from a Ponzi scheme, the district court correctly calculated the net loss
and realized losses they have sustained without working an unfairness that is endemic in other methodologies – particularly the recently popular net-investment approach. It has the added benefit of unifying the criminal and civil proceedings, saving both time and judicial resources as the calculation of loss among all civil parties can be simply aggregated to determine the quantifiable loss the operator is charged with in the criminal proceedings.

Section II lays out the standard of review used by appellate courts and the wide latitude district courts are given in approving allocation rules among innocent victims in cases of fraud. It argues that a lack of discipline among these courts has created uncertainty among both creditor victims and receivers, and accordingly needs to be more sharply refined into a preference for a single approach.

Section III looks at the different kinds of creditor victims to a Ponzi scheme – mainly those that are secured and those that are unsecured. It uses principles of contract law, business law, and securities law to argue that secured creditors ought to indeed recover the full amount of their secured interest before unsecured creditors because such a rule rewards investors who inquire into the business practices of a potential recipient of funds. The nature of a Ponzi scheme ensures that no investor can offer secured positions for every new investor for very long without the scheme being discovered. Therefore, incentivizing secured positions makes it more likely that a fraudulent scheme will be uncovered more quickly.

Section IV lays out the basic allocation rules used by receivers and approved by courts for the allocation of remaining assets and losses when a Ponzi scheme finally unravels. It starts

---

14 Each secured interest would require real assets of equivalent value. While one could buy real assets with others money and use that property to secure additional loans, the scheme only works so long as the amount of secured property is equal to the value of the funds borrowed. As soon as the Ponzi scheme makes an interest payment to initial creditors, or the Ponzi operator absconds with the last loan, the scheme would be discovered and by virtue of the secured positions, virtually all creditors could fully recover their loss.
with a discussion of the net-investment approach, which is currently the most commonly used rule. It moves on to discuss two alternate approaches, recession and restitution and the loss to the losing victim. Derived alternately from civil and criminal law, these allocation methods allocate loss differently from the net-investment and are indeed preferable for the unique case of Ponzi schemes.

Finally, Part V makes the case that when deciding between the different principles articulated by the loss allocation rules, the nature of a Ponzi scheme needs to factor into a courts choice of approved method. While the net-investment approach may be more appropriate in other instances of securities fraud – the unique nature of a Ponzi scheme requires an alternative allocation approach that looks not to whatever returns were generated, but to the legitimate expectations of equally innocent creditors and corrects for time by allocating loss and distributing the remaining assets according to the actual and realized losses of the creditors.

II. Courts Have Discretion to Determine Evaluation

Ponzi schemes are a unique kind of fraud with four basic elements; capital infusion from investors, the fraud itself, payments to investors which necessitate ever increasing new investment to perpetuate the fraud, and finally absurdly high interest rates which induce investment. The scope of the fraud can cover a myriad of industries, but always involves the Ponzi scheme operator asserting the investor’s capital is being used to generate the profit the returns are predicated upon, when in reality they are being used to pay investors the false return

---


16 *Id.* at 208 (“It could be almost any kind of business. We have famous ones, including a lot of pay phone deals years ago where people were putting money into pay phones, getting not crazy returns but 14% a year or something like that, and the businesses were real in that they had thousands of pay phones and money coming in. When you broke down the financial analysis, however, the pay phone businesses were losing money”) (Citing William Hick, U.S. Securities and Exchange Commission).
on investment accordingly inducing new investment while permitting the Ponzi operator to misappropriate millions of other peoples dollars.\textsuperscript{17}

In cases of fraud, and Ponzi schemes in particular, a receiver is regularly appointed to guard the remaining assets after the fraud is finally uncovered.\textsuperscript{18} It is the receiver’s responsibility to protect whatever assets remain, liquidating and recovering whatever it can to return as much as possible to the innocent investors. The receiver, not the court, is the body that ultimately makes payments to claimants. This often leads to the common misperception that it is the receiver, not the court, that is ultimately in charge of determining the loss of each party and allocating whatever funds were recovered among them.

The district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership.\textsuperscript{19} It is the Court, not the receiver\textsuperscript{20} or state law,\textsuperscript{21} that governs allocation. This makes the receiver an officer of the court, not an independent agent,\textsuperscript{22} so although the receiver may issue preliminary findings or recommendations regarding the methods of determination and allocation of loss, the Court is the agent that ultimately reviews and ratifies

\textsuperscript{17} Craig T. Lutterbein \textit{Fraud and Deceit Abound: But do the Bankruptcy Courts Really Believe Everyone is Crooked? The Bayou Decision and the Narrowing of Good Faith} 18 Am. Bankr. Inst. L. Rev. 405 (2010) (“In Ponzi schemes, early investors are simply paid from the investments of later investors”).

\textsuperscript{18} \textit{SEC v. Presto Telecom. Inc.}, 153 Fed. Appx. 428 (9th Cir., 2005) (“The district court did not abuse its discretion by invoking its inherent equitable power to appoint a receiver”), \textit{SEC v. Wencke}, 622 F.2d 1363 (9th Cir., 1980) (“The power of a district court to impose a receivership or grant other forms of ancillary relief does not in the first instance depend on a statutory grant of power from the securities laws. Rather, the authority derives from the inherent power of a court of equity to fashion effective relief”).

\textsuperscript{19} \textit{SEC v. Capital Consultants, LLC}, 397 F. 3d 733, 738 (9th Cir., 2005) (“A district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad”) See also \textit{SEC v. Pension Fund of America L.C.} Case# 09-10241 Filed May 6, 2010 (11th Cir., 2010).

\textsuperscript{20} \textit{SEC v. American Principals Holding Inc.}, 926 F.2d 1402, 1409 (9th Cir., 1992) (holding that a Receiver manages property under the authority of the Court).

\textsuperscript{21} \textit{Dzikowski v. N. Trust Bank of Fla., N.A.} 478 F.3d 1291 (11th Cir., 2007) (“the federal rule of single satisfaction requires the bankruptcy court to allocate the amount of the settlement that applies to the complaint against Northern Trust rather than apply Florida law).

\textsuperscript{22} \textit{N. Am. Broad., LLC v. United States}, 306 Fed. Appx. 371 (9th Cir., 2008) (“The property in his hands is in custodia legis; it is the court itself that has the care of the property in dispute. The receiver is but the creature of the court having no powers except such as are conferred upon him by the order of his appointment and the course and practice of the court”) citing \textit{Booth v. Clark}, 58 U.S. 322 (1854).
Whenever the method of allocation is contested, or the Court’s order approving the receivership is unclear, no creditors will receive satisfaction of their claims against a Ponzi operator without the Court’s ratification of the allocation scheme.  

A district court's decision concerning the supervision of an equitable receivership is reviewed only for abuse of discretion. The basis for this broad deference to the district court's supervisory role in equity receiverships arises out of the fact that most receiverships involve multiple parties and complex transactions. The amount of deference provided to the allocation judgments of district courts makes intuitive sense. A trial judge spends countless hours in a large and complex fraud case evaluating the claims of a variety of parties, from individual investors to insurance companies, from banks that extended lines of credit to commercial real estate companies that hold contracts with defaulted lease payments. The creditors can number in the thousands or tens of thousands depending upon the scale of the fraud. Reviewing the lower court record solely for abuse of discretion allows these complex and burdensome cases to be more expeditiously completed and conserves judicial resources. As a corollary, district courts have a great deal of leeway when it comes to ratifying different methods to determine loss and allocate assets, confident that the standard of review is broad enough to permit them to

---

23 Crites, Inc. v. Prudential Ins. Co. of America, 322 U.S. 408, 414 (1944) (Holding that a receiver is an arm of the court “Simkins was also an officer or arm of the court. He was appointed to assist the court in protecting and preserving, for the benefit of all parties concerned, the properties in the court’s custody pending the foreclosure proceedings”) See also Davis v Gray, 83 U.S. 203 (1873)  
24 Id.  
25 SEC v. Loving Spirit Found., 392 F.3d 486 (D.C. Cir., 2004) (“the district court exercised its "extremely broad" supervisory power over an ongoing receivership”), SEC v. Lincoln Thrift Association, 577 F.2d 600, 606-609 (9th Cir. 1978) (“The question to be resolved by this Court, then, is whether the district court judge abused his discretion in failing to grant appellant creditors the relief they sought”), see also SEC v. Safety Finance Service, Inc., 674 F.2d 368, 372-373 (5th Cir. 1982), SEC v. An-Car Oil Co., 604 F.2d 114, 119 (1st Cir. 1979).  
26 SEC v. Hardy, 803 F.2d 1034 (9th Cir., 1987) citing SEC v. Safety Finance Service, Inc., 674 F.2d 368, 373 (5th Cir. 1982) (a court overseeing a receivership is accorded "wide discretionary powers" in light of "the concern for orderly administration").  
independently evaluate the parties and the facts to determine most equitable methodology to allocate loss without concerning themselves with the possibility of being overturned upon appeal.\(^\text{28}\)

The lack of discipline by District Courts to use a single method is problematic. Serious problems arise when determining valuation because different receivers propose different methods of allocating loss among potential creditors. When these methods are variously affirmed by the Courts, it creates a patchwork of different methodologies with virtually no criterion to choose between the various allocation calculations.\(^\text{29}\) Receivers, creditors, and the financial system writ large would benefit from rules so clearly articulated as to approach a single standard method of determining loss in situations of securities fraud. That allocation rule ought to be the loss to the losing victim method.

### III. Secured v. Unsecured Creditors

Before addressing the allocation of loss among innocent victims in a Ponzi scheme, it is first necessary to briefly discuss the different classes of creditors. It has long been established that similarly situated creditors ought to be treated similarly,\(^\text{30}\) however there is an open question regarding which parties are properly termed to be similarly situated. While there can be no

\(^{28}\) These include the net investment approach, the rescission and restitution method, and the loss to the losing victim calculation. Each of these methods, and their comparative merits, are discussed further below.

\(^{29}\) The result is that courts apply different allocation methodologies to different sets of facts and adopt allocation rules that most neatly comport to the transaction’s paper trail. While there are obvious advantages to a flexible system, they are dwarfed by the inefficiency and uncertainty ultimately created. What results is a nearly endless appeal process on the question of validation, which slows up liquidation and distribution and is accordingly inequitable and inefficient.

\(^{30}\) *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) (“[T]he court should aim to treat similarly situated creditors similarly, and to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default”).
argument that superficial differences do not justify special treatment, whether a party is a secured creditor does justify separate allocation of recovery.

The law has long distinguished secured from unsecured claimants; “all creditors similarly situated are treated equally; secured creditors are given advantages that unsecured creditors do not have.” The Supreme Court agrees. This preferential treatment is why one seeks out investment opportunities with the attenuated securities. Parties that make unsecured loans in different amounts, on different days, for different term lengths, and at different rates of interest may all be properly considered similarly situated, however, a secured party, one that conditions their participation on a secured interest in property or other form of security is, as case law demonstrates, fundamentally in a different class from other unsecured creditors.

Is this equitable? Yes. In a Ponzi scheme the recoverable assets will eventually be fixed, meaning that a gain to one party is a loss to all others because recovery is essentially zero-sum. Yet, parties still have an incentive to cooperate, regardless of whether they hold a secured or unsecured claim, all parties have an incentive to defeat claims that are “false, exaggerated, time-barred, defensible on the merits, or otherwise avoidable.” Secured and unsecured parties will also collaborate to dismiss indirect claimants whose loss was created when they invested in an entity that then reinvested their funds in the Ponzi scheme. These individuals have a claim.

31 Examples include agreements entered into on different days of the week, on different dates, for different amounts of money, with different rates of interest, in different locations, etc.
32 In Re Nixon 34 F.2d 667 (N.D. OK., 1929).
33 Till v. SCS Credit Corporation 541 U.S. 465, 477 (n.16) and 504 (n.15 Scalia dissenting on other issues) (2004) (Distinguishing between secured creditor and unsecured creditor as fundamentally different classes of creditors in a bankruptcy).
35 David Gray Carlson, Secured Lending as a Zero-Sum Game, 19 Cardozo L. Rev. 1635, 1652 (1998) (“Whatever risk is removed from the secured creditor's claim is added to the unsecured creditors’ claims”).
36 Geoffrey C. Hazard, Jr., John L. Gedid, and Stephen Sowle, An Historic Analysis of the Binding Effect of Class Suits, 146 U. Pa. L. Rev. 1849, 1891 (“Although there are conflicts of interest among creditors, there are also common interests, and these common interests predominate in the usual case. This configuration of interests permits and justifies a representative action aimed at collecting the assets and regulating their distribution”).
against the party they directly placed their capital with, which will in turn bring claims properly against the Ponzi scheme itself, thus preventing an investor from recovering twice. Finally, they are also incentivized to work together to find all possible assets, whether secured or unsecured, because these will increase the eventual size of the pool for all claimants. 37

Treating secured and unsecured creditors separately also provides all parties with the benefit of their bargain. 38 When the parties contract for a secured interest in collateral, and the eventual assets available are insufficient to cover the pledged commitment “secured creditors are given the benefit of their bargain and various protections, such as adequate protection of their secured interest.” 39 While there have been instances where a court has denied a supposedly secured creditor the benefit of its secured position because the mortgages used to secure the investment were improperly recorded, 40 and denied preferential treatment when the claimant had already been made whole, 41 there are no instances of a court treating a properly secured creditor and unsecured creditor as similarly situated victims of a Ponzi scheme. 42

Certainly, there are instances where the amount of recovered capital is less than the total secured claims of creditors. In this instance, the unsecured creditors, while not legally barred

37 Id.
38 Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (In cases of misrepresentation, a party asserting a secured interest is entitled to the benefit of that security).
39 In re Barry Good LLC 400 B.R. 741 (D. AZ, 2008)
40 In re Corporate Financing 221 B.R. 671, 677 (E.D.N.Y. 1998) (The reason the initial set of investors were not treated as secured creditors was because the “mortgage loans to which they contributed were not properly recorded” and that the mortgages were secured for a group of investors through the scheme making the investors not direct participants in the mortgage transaction and therefore not entitled to a secured position).
41 First American Title Insurance Company v. Countrywide Home Loans Inc., No. 27-CV-05-7830 (Minn. State Dist., Feb. 15, 2007) (The Court recognized classes of creditors, holding that funds held in escrow were available only to third parties and not general creditors, and that because Countrywide had already “received substantial reimbursement of its losses” it was not entitled to recover in the present action).
42 Dana Yankowitz I Could Have Exempted It Anyway: Can a Trustee Avoid a Debtors Prepetition Transfer of Exemptible Property 23 Emory Bankr. Dev. J. 217, n.25 (2006) (“The Bankruptcy Code provides payment to creditors based on classification of their claims. See id. § 1129(a)(7)-(8). "Similarly situated" creditors are those creditors that are grouped in the same class (i.e., fully secured creditors, partially secured creditors, unsecured creditors, etc.). The policy of equality of distribution is referred to as "'equal treatment of similarly situated creditors' since the distribution provisions of the [Bankruptcy] Code are aimed at maintaining equality within distinct classes of creditors." Citing Rafael I. Pardo, On Proof of Preferential Effect, 55 Ala. L. Rev. 283, 326 n.11 (2004).”)
from recovery, will functionally recover nothing because they take only after the secured claims have been satisfied.\textsuperscript{43} This result, however inequitable it may appear on its face, is a logical construction of existing bankruptcy and security law.\textsuperscript{44} Additionally, because the assets of a Ponzi scheme are limited by the investment put in by prior creditors, a Ponzi operator cannot offer every party a secured interest in the full value of their investment for very long without the nature of fraudulent scheme uncovered by savvy investors or the financial system.\textsuperscript{45} Therefore, incentivizing behavior that encourages parties to obtain secured positions is a legitimate means of policing Ponzi operation.

In common accord with the above authority, it is clear that while similarly situated creditors may be treated similarly, secured and unsecured creditors are not similarly situated.\textsuperscript{46} Accordingly, equity and law require that courts recognize a secured party in a Ponzi scheme, and accord that secured party the benefit of its security. If the recoverable amount from the security is greater than the amount the court determines the secured party is eligible to recover, the residue from the liquidation or sale of the secured interest can then be allocated pro-rata among all other parties. If the amount a secured party is eligible to recover is greater than the sum total of their secured interest, the secured party can recover the entire value of its security, and have its claim to the unsecured funds reduced dollar for dollar against the security. In this way, the secured creditor is given the benefit of its bargain and all other parties recover a greater share of the unsecured assets, producing the only equitable result.

\textbf{IV. The Major Approaches}

\textsuperscript{43} \textit{Id.}
\textsuperscript{44} \textit{Id.}
\textsuperscript{45} A brief discussion of this proposition can be found Supra n. 14
\textsuperscript{46} A partially secured creditor is to be treated as a secured creditor for the portion of their investment so secured, and an unsecured creditor for the remainder. Yankowitz Supra n. 42.
After determining which creditors are properly secured, and what they hold as security, the court (or the receiver it appoints) must determine how much each claimant is owed. A corollary to the principle that similarly situated parties should be treated similarly is that all unsecured parties share in whatever assets remain on a pro-rata basis. While there are seldom disagreements over the principle of pro-rata allocation, the amount of loss each party is entitled to recover is incredibly contentious. Because the trial or district court’s decision concerning the method used to allocate loss is reviewed only for abuse of discretion, parties compete to convince the court to adopt their preferred method. Different ways of measuring loss result in substantially different outcomes for the parties, so the stakes at this stage are considerably greater than upon subsequent appellate review.

Given that the methodology used by the court to allocate loss is so important, and that courts have adopted different approaches depending upon the nature of the case and the specific facts, it is necessary to explore the differences between the approaches. After reviewing the more commonly applied net-investment approach, this article will posit two alternatives which often achieve a different and more equitable result. The first – rescission and restitution – has been adopted in Ponzi scheme cases by civil courts. The second – loss to the losing victims –

47 Cunningham v. Brown, 265 U.S. 1, 12-13 (1924) (“[W]here a fund was composed partly of a defrauded claimant’s money and partly of that of the wrongdoer, it would be presumed that in the fluctuations of the fund it was the wrongdoer’s purpose to draw out the money he could legally and honestly use rather than that of the claimant, and that the claimant might identify what remained as his res and assert his right to it by way of an equitable lien on the whole fund, or a proper pro rata share of it”) See also Claire Seaton Rosa, Should Owners Have to Share? An Examination of Forced Sharing in the Name of Fairness in Recent Multiple Fraud Victim Cases, 90 B.U.L. Rev. 1331 (2010).

48 Supra n. 25

49 Id. Because courts have found any number of allocation systems to be reasonable, it is considerably harder to prevail upon appeal when the standard is abuse of discretion. Accordingly, the most costly and most important part of Ponzi scheme litigation is often bound up in the District Court over questions of the best way to allocate the remaining dollars.

50 Commodity Futures Trading Commission v. Topworth International 205 F.3d 1107, 1116 (9th Cir., 2000) (Affirming the broad discretion courts have in allocating loss among parties in cases of fraud and discussing the various methods federal appellate courts have affirmed as within the discretion of the district court including the net investment or “net equity” approach as well as the rescission and restitution method which are both considered in greater detail in the following sections).
comes from criminal law, but is ripe for adaptation in the civil realm. Its underlying principles and equitable result make it the approach courts should adopt going forward.

A. Net Investment Approach

The net-investment approach is the most common means of allocating loss among victims of a fraudulent scheme. It stands for the basic proposition that “equity is equity” and so no individual should be permitted to profit at all, regardless of the nature of the scheme or the circumstances surrounding it, when the return on capital did not actually reflect real profits made as a result from investment. No matter how innocent the investor, and regardless of the amount of money or length of time it was invested, absolutely no return on capital is permitted. In fact, any overpayment made in the guise of “interest” or “return of principle” beyond that which was initially invested, is eligible for reclamation.

Under the net investment approach, an individual creditor’s loss is measured by first taking all of the funds loaned out to the Ponzi operator from the innocent investor. Then, assuming that because the scheme didn’t actually return the promised interest rate the amount of real return on that investment is actually zero, the total amount due to the creditor is only the

51 Paul Sinclair and Brendan McPherson The Sad Tale of Multiple Overlapping Transfers: Part IV 29-4 American Bankruptcy Institute 18 (2010) (Noting that when it comes to the method of valuation, “[n]umerous federal courts have noted and discussed this issue in-depth over many decades.” The authors ultimately point to a trend in favor of the net-investment approach, also known as the “cash in/cash out” or “net equity” method because it is the simplest for the court to apply). For example, the largest and most well publicized Ponzi scheme of the recent economic crisis -Bernard Madoff Investment Securities – will allocate the loss of its creditors using the net-investment method. Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities 429 B.R. 423 (Bankr. S.D.N.Y. 2010) (“On March 1, 2010, after briefing and oral argument, the Court issued a decision (the ‘Net Equity Decision’) approving the Trustee’s method of calculating a customer’s Net Equity as the amount of cash deposited into the customer’s BLMIS account, less any amounts withdrawn from the customer’s BLMIS account (the ‘Net Investment Method’”).
52 Cunningham v. Brown 265 U.S. 1, 12 (1924).
53 Id.
54 Infra n. 103
55 Id. See also SEC v. Capital Consultants, LLC, 397 F.3d 733, 737 (9th Cir., 2005) (“The distribution plan provides for dividends to clients under a money-in-money-out or "MIMO" formula. Under this formula, the client's net loss is measured by the total amount invested in private assets (money in) minus the total amount returned to the client before the receivership (money out)).
amount the creditor loaned out – functionally an investment at 0% interest.56 Accordingly, the net investment approach assumes that any return on that investment is the repayment of principle, or perhaps more accurately, a repayment of interest at 0% with all payments in excess of the interest payment credited toward a repayment on principle.57 Thus when the net investment approach is used to calculate an individual’s loss for the purpose of allocating assets in a Ponzi scheme, every dollar returned – whether originally assumed to be the repayment of principle or the payment of interest and regardless of whether any of the returned funds were earned by legitimate means – is assumed to functionally be a return of principle.58

The final calculation of the net investment approach is thus measured by a combination of dollars in, dollars out.59 If the end result is that the creditor received more dollars in return from the scheme than he or she is proportionally entitled to given the total amount of dollars accounted for and adjusting for whatever security interests the parties hold, the creditor is

56 Id. See also In re New York Times Securities Services 371 F.3d 68, 74 (2nd Cir., 2004) (“Amounts shown on the claimants’ account statements as dividends or interest earned on the bogus funds were not included in the calculus”), Focht v. Athens 311 B.R. 607, 617 (M.D. FL, 2002) (“Each claimants’ claim must be reduced by any amounts the claimant received from [the fraudulent investment firm], whether as "interest," return of principal, or any other payment”).

57 SEC v. Byers, 637 F. Supp. 2d 166, 174 (S.D.N.Y. 2009) (“it is important to remember that each investor’s recovery comes at the expense of others”), Focht v. Athens 311 B.R. 607, 617 (M.D. FL, 2002) (No one disputes that the interest payments were not in fact interest at all, but were merely portions of other victims’ capital investments”)

58 See SEC v. Capital Consultants Supra n. 19 at n.5 finding that the net investment approach concludes that all “principle paydowns, interest payments, or other payments in funds, securities, or other property credited to a clients account” shall all be determined to be repayments of principle. See also Sinclair and McPherson Supra n. 51. (Discussing the policy arguments against the principle that “equity is equity” and instead favoring an allocation scheme that permits the recovery of at least reduced interest, or a rate of interest determined by regulation or statute. The justification relies both on investor expectations and the time value of money. A more thorough discussion of both of these principles is found in the next two sections).

responsible for the return of funds.\textsuperscript{60} Even less equitably, if the amount returned is less than the amount paid in, but more than the investor’s pro-rata share of the remaining assets, that difference may also be “clawed back” by the receiver.\textsuperscript{61} If the end result is that the creditor received fewer dollars in return from the scheme than she or he would be proportionally entitled to, the creditor will benefit by receiving the difference from the receiver.\textsuperscript{62} Under this supposedly equitable approach, investors are not given the benefit of their bargains, but are all forced to share equally with the losses of the scheme.\textsuperscript{63}

The net investment approach is the most common way that courts have allocated loss among parties in cases of securities fraud.\textsuperscript{64} It has the benefit of being fairly easy to calculate, particularly since neither the court nor the receiver need to make a determination regarding whether funds were attempts to return principle or payments of interest on principle invested.\textsuperscript{65}

However, in the special case of Ponzi schemes, the net investment approach fails to take into account some fairly basic elements of the fraud. The temporal element is the most important. Because an innocent investor who lends funds to a Ponzi scheme expecting a large return has actually lent funds that permit the scheme to perpetuate itself by inducing new investors, the first investor, although equally innocent like the last investor, loses considerably more. Other equitable considerations concern the loss of the investor’s benefit of their bargain, and confounding the rational expectations of all parties involved. A more thorough discussion of the failures of the net-investment approach can be found in section V infra.

\textsuperscript{60} Christine Hurt \textit{Evil Has A New Name: (And a New Narrative): Bernard Madoff} 2009 Mich. St. L. Rev. 947 (2009) (If the investor does not voluntarily return the excess funds to be redistributed to other creditors who received back less than their pro rata share of assets the receiver can “claw back” these overpayments from Ponzi scheme under authority of 15 U.S.C. § 78fff-2(c)(3) (2006)).
\textsuperscript{61} Id.
\textsuperscript{62} Supra n. 59 (Discussing the pro rata allocation requirements under the net-investment approach).
\textsuperscript{63} In re Tedlock Cattle Company 552 F.2d 1351 (9th Cir., 1977) (“Under the equity theory, no investor creditor will receive the benefit of his bargain, but all will share some recovery”).
\textsuperscript{64} Sinclair and McPherson Supra n. 51
\textsuperscript{65} Id.
To rectify the many problems associated with the net-investment approach, I propose that federal courts – for the special case of Ponzi schemes – should instead distribute loss using one of two less often used, but more equitable methods to allocate loss among all victims of a Ponzi scheme.

B. Rescission and Restitution

The rescission and restitution method of allocating the loss of individual innocent lenders in a Ponzi scheme is taken from principles of contract law and principles of equity.\textsuperscript{66} It intends not to discount or reduce the total loss as much as possible (which is too often the result of the net investment approach) but instead intends to compensates parties based upon their realized loss.\textsuperscript{67} It is calculated by taking the principle that each lender was induced to provide to the Ponzi scheme operator and then subsequently reduces the amount by the return of all principle.\textsuperscript{68} Different variations on its calculation alternately account dividend reinvestment as principle or interest – a determination that is made by the court and based upon the specific facts of each case.

\textsuperscript{66} Andrew Kull, \textit{Rescission and Restitution}, 61 Bus. Law 569 (2006) (“in the vicinity of contracts disputes, where "restitution" sometimes refers to an action based on unjust enrichment (normally where the claimant has no contract rights to enforce), but sometimes refers to a remedy for breach, available to a party who might otherwise seek expectation damages or specific performance”), Andrew Kull, \textit{Rationalizing Restitution} 83 Calif. L. Rev. 1191, 1219 (1995) (“When the Restatement of Restitution was adopted in 1936, there was only one context in which the word "restitution" was in common use as a legal term. The remedy of rescission, available for certain breaches of contract, was frequently called "rescission and restitution." This was straightforward descriptive terminology, because rescission of a contract, most of the time, is inevitably a two-step process”).

\textsuperscript{67} \textit{Id. Rescission and Restitution} (“restore to the injured party something previously given to the defendant by way of performance, or they restore the injured party to the precontractual status quo, or they do both of these things at once”), see also Commodities Futures Trading Commission v. Richwell International Ltd., 163 B.R. 161 (Bankr. N.D. Cal., 1994) (Payment is returned to all parties on a pro rata basis based upon the net deposits to the account), \textit{In re Trending Cycles for Commodities, Inc.}, 27 B.R. 709, 710 (Bankr. S. D. Fla. 1983) (Court approved a plan under the rescission and restitution formula that was “equal to the total out-of-pocket deposit made by a customer minus withdrawals”).

\textsuperscript{68} \textit{Id. at} 162-163. The important difference between the “net investment” and the “rescission and restitution” method is not that the ultimate loss is allocated on a pro-rata basis, but rather the total amount of the loss. \textit{Richwell} is clear that after the total loss is determined, the remaining assets are allocated pro-rata under the rescission and restitution approach. (“[D]istribute the remaining general property to both past and present customers \textit{pro rata} under a rescission and restitution formula, paying them in proportion to their total lost money”).
and the appropriateness of its inclusion given the standard business practice of the scheme. It notably excludes a reduction in the amount returned as interest. Using this method, the aggregate amount of loss will be significantly greater because no discount is given for the return of interest. However, because allocation of loss is pro-rata each party is still returned the proportional share of loss they are entitled to without sacrificing contract principles or the expectation of each individual creditor. To avoid excessive profits from willful ignorance, the court need only apply its current rules denying recovery to anyone who knew or should have known the scheme was fraudulent.

The most commonly cited case in favor of the rescission and restitution approach is *Commodities Futures Trading Commission v. Richwell International Ltd.* In *Richwell*, the District Court approved a plan that distributed the remaining assets to existing creditors under a scheme that entitled those creditors who made profits to claim their entire principle as their loss. The Court considered other approaches, but determined that accounting for the realized gains of some parties would legitimize the illegal operation, that recovering based upon

---

69 *In re New Times Secs Servs., Inc.*, 371 F.3d 68, 71 (2nd Cir., 2004) (A Court applying the rescission and restitution method may determine on a case by case basis whether any interest or dividends not paid in cash but returned on paper through a dividend reinvestment scheme should be counted as a return of principle for the purpose of allocating loss among innocent investors. “Instead, each Claimant’s net equity should be calculated by reference to the amount of money the Claimants originally invested with the Debtors not including any fictitious interest or dividend reinvestments”).

70 Supra n. 67. (The important difference between the net investment approach and the rescission and restitution approach is that while the former discounts the principle deposits by a return on principle and interest, the latter only discounts the loss by the amount of the original deposit that has been returned as principle).

71 Courts have found promised rates of return to be so high, that anyone accepting them knew or should have known that the scheme was fraudulent and is accordingly denied those fictitious prophets. *Scholes v. Lehman* infra n. 108. Judge Posner reminds us all that is something sounds too good to be true, is probably is.

72 *Commodities Futures Trading Commission v. Richwell International Ltd.*, 163 B.R. 161 (N.D. Cal., 1994)

73 *Id.* at 164

74 *Id.* ("[T]o impose a constructive trust on specific assets for specific customers, at the expense of other similarly situated customers, would be inequitable").
actualized loss better tracked creditor expectations than reducing the loss by any realized gains,\textsuperscript{75} and that equity demanded a scheme that accounted for the principle.\textsuperscript{76}

The rescission and restitution method is not solely the construction of a single federal court. The Securities Investor Protection Corporation believes that expectations of an innocent investor ought to be protected even in circumstances, such as a Ponzi scheme, where those expectations are inconsistent with the reality of the invested funds.\textsuperscript{77} The SIPC\textsuperscript{78} was created in response to a federal mandate in the Securities Investor Protection Act\textsuperscript{79} and exists to protect investors in the event of a brokerage failure. The endorsement of the SIPC demonstrates that the rescission and restitution method should be considered as a serious alternative to the net-investment approach.

Under the \textit{Richwell} approach, the principle of each creditor’s initial loan is used to determine their realized loss and accordingly their proportion of recovered assets.\textsuperscript{80} Transactions in a Ponzi scheme are often much closer to that of lender – borrower than a purely speculative equities investor. Innocent creditors are often convinced they are providing funds for business expansion and development rather than speculating in foreign currencies, stocks, or the bond

\textsuperscript{75} Id. (“those who are victims of theft or fraud expect to receive their property back if it is possible to actually identify what property is theirs”).

\textsuperscript{76} Id. (Equity demands “distribut[ing] remaining customer property to existing "public customers" pro rata on the basis of the lesser of (a) current account balance on September 23, 1993, and (b) their total net deposits into their margin account” but the Court notes that company insiders and family members, not being public customers, are not able to recover as they are the ones who should have known about the fraud).

\textsuperscript{77} Sinclair and McPherson Supra n. 51 (“[R]easonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional reality.”)

\textsuperscript{78}The Securities Investor Protection Corporation was mandated by Congress to be a non-profit watch dog and advocate on behalf of investors in securities against the exigencies of the market and personal greed endemic in such a system. Their mandate and how they are responding to the new instances of fraud uncovered by the economic crisis at the end of the first decade of the twenty-first century can be found at their website. www.sipc.org

\textsuperscript{79} 15 U.S.C. 78aaa (Securities Investor Protection Act)

\textsuperscript{80} Id. at 161 (recovery is based upon “net deposits”), see also \textit{In re Trending Cycles for Commodities, Inc.} Supra note 67 (recovery is based upon the “total deposits” minus any withdrawals).
Accordingly, the rescission and restitution approach better tracks the expectations of all creditors and does not unfairly discriminate depending on the rate of return promised or the length of time the claimant had been involved. The court in Richwell also concluded that focusing on anything but the principle loaned and the repayment of principle received would be contrary to “public policy” because it would give the “appearance of legitimacy” to the otherwise fraudulent transaction. Finally, it ensures equity is achieved better than the net investment approach by indexing the proportion of recovery of each party to the proportion of dollars initially invested – giving each party the benefit of their bargain, “those who are victims of theft or fraud expect to receive their property back if it is possible to actually identify what property is theirs.”

C. Loss to the Losing Victim

Like the rescission and restitution method that originated as an equitable alternative to the net investment approach, the loss to the losing victim method attempts to evaluate the loss of each party by conceptualizing the total amount the Ponzi scheme operator fraudulently induced innocent lenders to contribute and then reduces those losses when appropriate.

Circuit Courts have recognized that Ponzi schemes are a unique kind of fraud, one where “any gain realized by an individual investor is designed to lure others into the fraudulent

---

81 In re Petters Company Inc., 425 B.R. 534 (2010) (In the case of Tom Petters the Ponzi scheme included providing capital to purchase such well known brands as Polaroid, Fingerhut, and Sun Country Airline, conglomerating these companies into Petters Company Worldwide, and continuing to fraudulently induce investors to provide capital for the new corporation).
82 Richwell Supra note 72
83 Id. at 164 (“ultimately the [rescission and restitution method] affects the most equitable compromise. It tracks investor expectations without legitimizing the trading operation by recognizing profits”).
84 Id. at 163-164.
85 Richwell Supra note 72
86 United States v. Alfonso 479 F.3d 570, 573 (8th Cir., 2007) (“Fraudulent schemes, however, come in various forms, and we must consider the nature of the scheme in determining what method is to be used to calculate the harm caused or intended”).
scheme.”

Ponzi scheme operators do not provide investors with gains out of the goodness of their hearts or to lessen damage to investors, but to keep their fraudulent schemes running. 

“[T]hose gains may also entice that same investor to make further contributions to the fraudulent enterprise. A repeat investor is essentially in the same position as a new investor for these purposes.” Accordingly, the loss to losing victim method holds that “a victim’s gain should be used to offset neither losses to another victim nor losses to that same victim later on in the scheme.”

The justification for the loss to the losing victim method is to ensure that all parties are entitled to the benefit of their bargain. While originating in criminal law to ensure that a Ponzi scheme operator cannot unfairly discount payments made to perpetuate the fraud, it also serves to protect the innocent investor significantly better than the net investment approach. The loss to the losing victim method determines the loss of each party by calculating the principle invested minus the principle repaid, thus arriving at every party’s real and actual loss. Every

---

87 Id. at 572 see also United States v. Orton 73 F.3d 331 at 334 (1996) (“Indeed, the very nature of the scheme contemplates payments to earlier victims in order to sustain and conceal the fraudulent conduct”).
88 See Alfonso Supra n. 86 at 571 (“Alfonso also used the money to perpetuate the scheme by providing some individuals with a profit on their investments in order to encourage further investment”).
89 Id. at 573
90 Id. at 574. See also Orton supra note 87 at 334 (The loss to losing victims “method takes into consideration the nature of a Ponzi scheme by holding a defendant fully accountable for all losses suffered by those victims who lose money, but does not allow the defendant to fully benefit from payments made to others. It does not reward a defendant who returns money in excess of an individual’s initial “investment” solely to entice additional investments and conceal the fraudulent conduct”), United States v. Hartstein 500 F.3d 790 (8th Cir. 2007) (The loss to the losing victim method “precludes the offsetting of one victim’s earlier gains or profits against that same victim’s own later losses”).
91 John D. Cline Calculation of Loss Under the Sentencing Guidelines 9 Geo. Mason L. Rev. 357 (2000) (“In a Ponzi scheme, early investors are repaid to encourage others to invest… the 'loss to losing victims' method… counts the losses suffered by investors who lost all or part of their money without any offset for the amounts repaid to other investors”).
92 See equity arguments made in Richwell Supra n. 72 (calculating each victim’s loss based upon the amount invested and discounting only returned principle but not interest is the most equitable means of allocating loss because it tracks the expectations of the parties, does not discriminate among equally innocent investors based upon when they were induced to invest in the fraudulent scheme, and does not validate the scheme’s transfer of funds among innocent parties.)
93 Frank O. Bowman III, A Judicious Solution: The Criminal Law Committee Draft Redefinition of the ‘Loss’ Concept in Economic Crime Setting 9 Geo. Mason L. Rev. 451, 480 (2000) (“In a case involving a fraudulent...
dollar repaid against the principle investment reduces the claim of an innocent victim by one
dollar. This better meets the expectations of all parties involved who rightly expect that should
something go wrong with the loan, they be entitled to recover their principle. Under the loss to
the losing victim method, no party is entitled to recover against their principle more than they
invested, but each party’s loss of principle is fully accounted for without complicated formulas
like the net investment approach which discounts the principle to be repaid significantly more
against some parties than others in ways that defy equity.94

Applying the loss to the losing victim method to calculate loss not only in criminal cases
that prosecute Ponzi scheme operators but also in civil suits that allocate the loss among innocent
investors creates equity among all investors regardless of when they arrived. This is an element
of a Ponzi scheme that is not found in other forms of fraud, because as the Court explained in
Alfonso, a Ponzi operator uses the principle from early investors to attract new investors, to
secure reinvestment by initial parties, and to perpetuate the fraud – thus uniquely damaging the
interests of those who arrive first.95 Unlike the loss to the losing victim approach, in a Ponzi
scheme the net investment approach penalizes early investors who would not have continued
investing in the scheme had they known about the fraud.96 These innocent parties deserve to

______________________________________________________________________________

94 Id.
95 Richwell supra note 72 at 163 (Removing interest from the equation and focuses solely on the principle invested
minus the principle returned “would be most equitable in spreading the losses amongst current and former
customers… because former customers are often those who report illegal trading operations, the CFTC asserts that
treating all customers equally will encourage former customers to report illegal operations such as Richwell”).
96 Sender v. C & R Co., 149 B.R. 941, 944-945 (D. CO, 1992) (“the operator will pay investors who request
withdrawals of falsely inflated account balances out of new investments, which frequently results in early investors
profiting at the expense of later investors”).
recover their principle in the same proportion to investors who arrived later, since all parties are equally innocent.

The loss to the losing victim method is not difficult to calculate. The Court in Alfonso provided a very helpful example. One victim contributed a total of $301,000 to a Ponzi scheme in two separate investments, the second being induced by a perceived return from the first.\textsuperscript{97} The first contribution of $36,000 in principle yielded $8,000 in interest. The victim was thus induced to invest an additional $265,000 of which $110,000 in principle was repaid. The Court determined loss by excluding the interest (gain) realized by the innocent victim – taking the $301,000 total principle invested by the innocent victim and subtracting only the $147,000 of principle repaid.\textsuperscript{98} The allocated loss in this instance is $8,000 greater than the loss calculated using the net investment approach. The Court reasoned that this greater loss amount is equitable because of the unique nature of Ponzi schemes, the larger second investment would never have been transacted if the fraudulent operator had not returned an interest payment on the initial amount.\textsuperscript{99}

The Loss to the Losing Victim method has thus far been confined to criminal law, when prosecutors are trying to realize the total amount of funds misappropriated from Ponzi scheme operators. However, because the total amount of loss for each party needs to be aggregated in order to determine the appropriate criminal sanction, and its principles follow that of an accepted allocation methodology – the rescission and restitution method described above - it would conserve tremendous judicial resources if courts would adopt the Loss to the Losing Victim’s allocation rules to the total loss of each civil creditor in the bankruptcy and resulting civil suit.

\textsuperscript{97} Alfonso supra note 86
\textsuperscript{98} Id. at 572. See also United States v. Hartstein 500 F.3d 790, n. 4 (8th Cir., 2007) (reaffirming the same basic fact pattern as the appropriate and equitable means of calculating the loss to the losing victim method to determine the loss of an individual party in a Ponzi scheme).
\textsuperscript{99} Id.
V: Equitable Valuation: The Special Case of Ponzi Schemes

Having laid out the two traditional civil approaches courts have used to allocate loss among parties in a Ponzi scheme and a third approach originating in criminal law but providing a reasonable basis and an equitable result if adopted in civil proceedings, some qualitative analysis is warranted to assist courts in choosing between these alternatives. After considering the policy implications of each approach as applied to Ponzi schemes it is clear that courts should deviate from the net investment approach in favor of the loss to innocent victim method. By consistently accounting for the entire value of the principle put up and reducing that value by any principle returned as dictated by the rescission and restitution and loss to the losing victim methods, courts award all innocent creditors the benefit of their bargain, affirm traditional contract and equitable principles, and affirm the allocation method that minimizes the discretion of the receiver to achieve the most consistent result.

The recession and restitution and loss to the losing victim methods, unlike the net investment approach, avoid lengthy and costly litigation against innocent parties in an attempt to “claw-back” past distributions from wholly innocent investors. In clear contravention of the parties expectations, the net investment approach would sanction the use of claw-back

---

100 Cline supra note 91 (“The Eleventh Circuit has identified two potential approaches to calculating loss from a Ponzi scheme: (1) the 'loss to losing victims' method, which counts the losses suffered by investors who lost all or part of their money without any offset for the amounts repaid to other investors, and (2) the 'net loss' method, which subtracts the total amount the defendant paid out from the total amount he received”).
101 The Loss to the Losing Victim Method. Supra n. 90
102 Jeffery G. Hamilton Clawback Claims Against Innocent Investors: The SEC v. The Stanford Receiver 28-8 American Bankruptcy Institute 12 (2009) (Questioning the reasonability of claw-back provisions against innocent investors generally, in cases of Ponzi scheme specifically, and noting that in SEC v. Stanford International Bank Ltd. the cost of clawing back potentially undue profits is likely significantly greater than the profits that will eventually be recaptured).
103 Thomas A. Dubbs The Continuing Evolution of Securities Class Actions Symposium: A Scotch Verdict on ‘Circularity’ and Other Issues 2009 Wisc. L. Rev. 455 (2009) (“claw back," or disgorgement, [are] gains that are obtained by "winning" investors who sold their stock in a firm before fraud was disclosed by the firm. It thus assumes that those gains are wrongfully "captured," and should ultimately be netted against instances where such investors "lost" because of fraud announced by another firm”).
104 See Hurt Supra n. 60 (Discussing the ability of a receiver to “claw back” the interest payments transferred to innocent creditors in compliance with their contractual agreements to pay interest on the loans the scheme accepted).
mechanisms in its ultimate defense of equity is equity.\(^{105}\) By taking back funds that may have been reinvested or spent by innocent investors that had no expectation their gains were derived from fraudulent investments, the net investment approach purports to do the financial system ‘justice’ by properly allocating loss.\(^{106}\) The reality is much more devastating. While those innocent investors may be able to then claim a tax credit – since the return on investment they reported as income and paid capital gains taxes on has been clawed back – the loss of that capital, the time value of the investment, and the disruption of assets which may require ill-timed liquidation to satisfy the claw-back demand, all jeopardize investor confidence in the financial system.

Rescission and restitution and loss to the losing victim avoid these conflicts by denying the receiver the ability to claw back funds returned to the creditor to satisfy an obligation but still ensures that those responsible for the scheme do not profit from it. Importantly, neither of the latter approaches permits investors that participated in the fraud or should have known about the fraud from profiting from the scheme.\(^{107}\) While promised rates of return by some Ponzi operators are so large as to strain credulity and may in those instances limit the number of innocent creditors,\(^{108}\) most schemes have large classes of creditors who are plausibly innocent and thus should be immunized from the claw-back principles of the net-investment approach.\(^{109}\) Under

---

\(^{105}\) See Sinclair and McPherson supra n. 51

\(^{106}\) See In Re Petters Company Inc. Supra n. 81

\(^{107}\) Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund, Ltd.), 359 B.R. 510 (Bankr. S.D.N.Y., 2007) (“In determining whether or not a transferee lacked the requisite knowledge so as to have been acting in good faith, courts look to what the transferee objectively knew or should have known in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint”) (reversed on other grounds).

\(^{108}\) Scholes v. Lehman, 56 F.3d 750, 760 (7th Cir. 1995) (“Only a very foolish, very naive, very greedy, or very Machiavellian investor would jump at a chance to obtain a return on his passive investment of 10 to 20 percent a month (the Machiavellian being the one who plans to get out early, pocketing his winnings, before the Ponzi scheme collapses). It should be obvious that such returns are not available to passive investors in any known market, save from the operation of luck”) (Judge Posner).

\(^{109}\) The Honorable Paul W. Bonapfel, William Hicks, John Mills and Todd Neilson The Business Bankruptcy Panelponzi Schemes – Bankruptcy Court v. Federal Court Equity Receivership 26 Bank. Dev. J. 207 (2010) (“As to whether or not people knew or should have known, I think in recent times, that has been somewhat mitigated
any approach individuals who knowingly participate in, profit from, or help perpetuate a scheme they know to be fraudulent are barred from recovery under any theory of allocation.\textsuperscript{110} They lose their right to any profits wrongfully acquired and face additional civil as well as criminal penalties.\textsuperscript{111}

While each method of allocating the losses from a Ponzi scheme provides different winners and losers, for a significant subset of those investors, the windfalls made from other investments compensate them for the losses attributed to the fraud.\textsuperscript{112} In the aggregate, investors who are diversified, and thus essentially secured, against the risk of securities fraud would rather the allocation of loss be divided in a manner that bears the lowest costs of administration.\textsuperscript{113} Rescission and restitution or loss to the losing victim accomplishes this goal by minimizing the receivers claw-back costs only to those investors who were responsible for perpetrating the scheme, and thus targeted to return the largest sums of invested money with the least cost.

\begin{itemize}
\item[\textsuperscript{110}] 18 USCS § 1956 (Racketeering, Money Laundering)
\item[\textsuperscript{111}] Id.
\item[\textsuperscript{112}] Janet Cooper Anderson \textit{Rethinking Damages in Securities Class Actions} 48 Stan. L. Rev. 1487, 1502 (1996) (“Most market transactions involve persons who have traded before and will do so in the future… An investor who is completely diversified will be fully compensated for its trading losses that are due to securities fraud by windfalls on other transactions. Such investors have no need for further compensation obtained through litigation”). See also John C. Coffee, Jr., \textit{Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation}, 106 Colum. L. Rev. 1534 (2006), Donald C. Langevoort, \textit{On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability}, 42 Wake Forest L. Rev. 627, 632 (2007) (“the investor's loss is not the company's gain; instead, other investors pocket the gain. The other investor might be an executive in on the conspiracy, making it essentially an insider trading case, but it is much more likely that the counterparty was simply someone lucky enough to be on the right side of the trade. Scholars going back at least to Easterbrook and Fischel's classic analysis have pointed out that the net social harm from corporate fraud, therefore, is much less than is evident at first glance because of these offsetting gains to innocent parties, which the law makes no effort to take away”).
\item[\textsuperscript{113}] Anderson \textit{Id.} at 1502-1503(“Some other sanctions regime almost certainly could be better calibrated to achieve those goals, with substantially lower administrative costs”).
\end{itemize}
Rescission and restitution then partitions those profits equitably, on a pro rata basis, based upon the amount each party lost (was due) at the time the fraud was discovered.\footnote{Commodities Futures Trading Commission v. Richwell International Ltd., 163 B.R. 161 (Bankr. N.D. Cal., 1994) (Payment is returned to all parties on a pro rata basis based upon the net deposits to the account).}

While the net investment approach has an appropriate place in valuing other kinds of fraud, the latter two methodologies are superior to the net investment approach for victims of Ponzi schemes.\footnote{Commodity Futures Trading Commission v. Topworth International 205 F.3d 1107, 1116 (9th Cir., 2000) (Reaffirming the broad discretion the trial court has to determine a method of allocation, and providing that the rescission and restitution method works best when the amount each claimant has been fraudulently induced to invest is knowable).} Federal appellate courts have expressed a clear preference for the rescission and restitution method over the net investment approach, finding that it is more appropriate when the total number of injured claimants is known, the company has “detailed accounting records” and the initial amount of money invested for each proper claimant to the suit could be clearly identified such that no investor “would be left without recourse.”\footnote{Id.} The loss to the losing victim method would achieve the same positive approval from federal courts by expediting conflict resolution and minimizing excessive litigation should it be adapted for civil resolution as well as criminal sanction.

Moreover, the rescission and restitution approach and loss to the losing victim are far more equitable than the net investment approach. Functionally, courts are forced to choose between either permitting an innocent investor to recover interest on an investment where the funds were never used to actually make a return, or discount the value of the dollars invested altogether by functionally enforcing a loan with no interest, depleting the actual and real value of the investment because of the time value of money.\footnote{Paul Sinclair and Brendan McPherson The Sad Tale of Multiple Overlapping Transfers: Part IV 29-4 American Bankruptcy Institute 18 (2010) (“it would be inexcusable to adopt a supposedly equitable formula--where investors who have invested money with Madoff for years, and some for decades--and to ignore the time value of money”).}
Almost a century ago, Judge Learned Hand recognized the principle that the law, to be equitable, must take into account the time value of money; “[w]hatever may have been our archaic notions about interest, in modern financial communities a dollar today is worth more than a dollar next year, and to ignore the interval as immaterial is to contradict well-settled beliefs about value.”118 The principle, when apportioning loss among innocent investors in a Ponzi scheme is not completely lost today.119 As the rescission and restitution method demonstrates, it can be just as simple to allocate loss based upon the last account statements of all investors or by auditing the financial records kept by the scheme. Where such records do not exist, or are unreliable, the problem of verifying the veracity of the records is no more complicated under the rescission and restitution approach then under the net investment approach. Assuming reasonably reliable records, allocating loss based upon the amount owed each creditor at the time the scheme was discovered best reflects the investor’s expected total capital eligible for withdrawal and ensures that the innocent victims of the Ponzi scheme are able to realize some value accorded to their accounts by the time value of money.

VI: Conclusion

As a result of the global financial crisis, the next decade will bring with it a significant increase in costly and lengthy litigation dismantling billions of dollars from Ponzi schemes across the country. As courts process the claims of tens of thousands of creditors they will be charged with adjudicating the allocation methodology for both the loss of each creditor and their concomitant distribution or claw-back of only a portion of the initial investment.

118 Procter & Gamble Distribution Co. v. Sherman, 2 F.2d 165, 166 (S.D.N.Y. 1924).
119 Sinclair and McPherson Supra n. 64 citing In re Unified Commercial Capital Inc., 260 B.R. 343, 351-352 (Bankr. W.D.N.Y. 2001), "the universally accepted fundamental commercial principle that, when you loan an entity money for a period of time in good faith, you have given value and are entitled to a reasonable return").
To reduce costly appeals, conserve judicial resources, and streamline the process of winding down a Ponzi scheme courts need to implement a uniform method of allocating this loss. Given the comparative merits of each method, now is the time to part ways with the rigid and inflexible proposition that equity and equity. To give all equally innocent creditors the benefit of their bargain, courts need now to remember that which Judge Learned Hand was prescient to note almost a century ago – that there is value in the time value of money. By moving away from the net investment approach and adopting the rescission and restitution or the loss to the losing victim method of allocating loss, courts will do a great service to the expectation of all players in the financial system.