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Will Investors Be Sued as Madoff Fraud Revelations Continue? Investors Who Received Returns Face Risks

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The December 11, 2008 revelation that Bernard L. Madoff, founder of Bernard L. Madoff Investment Securities ("Madoff Securities") and former NASDAQ stock market chairman, allegedly orchestrated one of the largest and most sophisticated Ponzi schemes in history undoubtedly leaves investors not only wondering if they will recover their investments, but also whether they may face exposure from lawsuits trying to take back the returns they were paid. The seizure and investigation of Madoff Securities will likely result in the recently appointed bankruptcy trustee closely examining whether it can recover monies paid to investors as part of the alleged scheme. A large majority of the investors are likely to be the target of fraudulent transfer actions and should, as such, be aware of ways to potentially minimize their exposure.

SEC Allegations

According to allegations in a complaint filed in the U.S. District Court for the Southern District of New York against Madoff by the Securities Exchange Commission ("SEC"), it appears that Madoff has been operating Madoff Securities by paying returns to certain investors out of the principal received from other, different, investors rather than from internally generated revenues. The SEC complaint describes his scheme as "a stunning fraud that appears to be of epic proportions." As part of its complaint, the SEC sought emergency relief for investors, including an asset freeze and the appointment of a receiver for Madoff Securities. The District Court ordered that the business be liquidated under the jurisdiction of the bankruptcy court. The process will be managed by Irvin Picard, who was appointed as the bankruptcy trustee.

In light of these developments, many investors in Madoff Securities should first be concerned not only about what will come of their existing investments but whether the bankruptcy trustee will be looking to recover funds paid by Madoff Securities to its investors. A central goal of the bankruptcy filing will be to ensure an orderly liquidation of Madoff Securities providing for a fair treatment of all investors. As part of achieving those goals, the bankruptcy trustee will be looking to collect as much money as possible for distribution to the investors and other creditors. These efforts will entail not only the examination of third parties who may have played a role—whether wittingly or unwittingly—in Madoff's scheme (*i.e.*, accountants and auditors) but also analysis of whether investors who received returns through the Ponzi scheme should be required to return funds to the estate.

Elements of a Fraudulent Transfer Claim

Though there are several causes of action that a bankruptcy trustee may pursue against investors in the context of a Ponzi scheme, a fraudulent transfer action is likely to be at the forefront. With respect to investors, fraudulent transfer claims filed by a bankruptcy trustee may allege that investors received fraudulent transfers under state law, the Bankruptcy Code or both. There are two basic types of fraudulent transfer claims: (i) those based on an actual intent to defraud, hinder or delay other creditors; and (ii) those based on constructive fraud. In a case of actual fraud, the bankruptcy trustee must prove the actual intent to hinder, delay or defraud creditors on the part of the party making the transfer. However, in a constructive fraudulent transfer case, intent is not an issue, and the legal questions focus on whether a transfer (i) was made before the date of the filing of the bankruptcy petition (this time period can be several years and depends on the applicable state law); (ii) was for less than a reasonably equivalent value in exchange for such transfer; and (iii) was made while the debtor was insolvent or the transfer caused it to be insolvent.

Where a trustee can prove that a company was operating as a pure Ponzi scheme, the trustee gains two key tactical advantages. *First,* the courts will find the company insolvent as a matter of law. *Second,* the trustee will generally enjoy a presumption that transfers to investors were, by definition, not for reasonably equivalent value because the transfer will have diminished the assets available for distribution among all of a debtor's creditors.

The Good Faith Defense May Offer Some Protection to Investors

Despite the presumption that transfers to investors were not for value in a Ponzi scheme case, investors still may be able to defend against allegations of a fraudulent transfer if the investor can demonstrate that the transfers were taken in good faith and that reasonably equivalent value was in fact given to the debtor. To demonstrate good faith, it is the investor's burden to show that it had no knowledge of the fraudulent conduct and had no reason to believe that the company it was investing with was involved in any improper fraudulent activities. The investor will need to show that it, as a diligent investor, did not know, and had no reason to know, that it was investing in a Ponzi scheme.

Courts will consider several of the following factors when determining whether an investor is entitled to a good faith defense in a Ponzi scheme context: (i) the investor's level of business knowledge and experience; (ii) the disparity between prevailing market rates of return and the rates of return promised by the Ponzi scheme on investments in its scheme; (iii) whether, as a general matter, the investor recognized the risky nature of the investments promising high rates of return; (iv) how the investor learned of the Ponzi scheme's investment scheme; (v) the type of due diligence investigation the investor made of the Ponzi scheme's investment scheme, including the plausibility of the Ponzi scheme's explanation for its promises of high rates of return; and (vi) whether the investor actually knew or suspected the Ponzi scheme was operating a fraudulent scheme, or knew or suspected that the Ponzi scheme was using monies from some investors to pay other investors.

In addition to demonstrating good faith, the investor will also need to show that it had provided value to the company and that was the basis for the funds that it received from the company. Courts will likely measure reasonably equivalent value by comparing the funds received by the company from the investor to the funds given to the investor in the course of the Ponzi scheme. In previous cases involving Ponzi schemes, some courts have held that, to the extent the investor received transfers of funds from the debtor representing the return of the investor's principal investment, such transfers are for reasonably equivalent value such that the investor did not have to return those funds. However, even where the creditor has demonstrated good faith, to the extent the funds the investor received represent returns beyond the principal investment, the courts have generally found that those funds have to be returned to the company.

In the case of the Madoff Securities Ponzi scheme, based on current news reports and allegations in the SEC's complaint, this alleged unprecedented scheme and fraud, which purportedly escaped the detection of several sophisticated investors and may have fooled auditors, examiners and regulatory authorities, investors may have an easier time asserting a good faith defense based on their lack of knowledge or reason to suspect a Ponzi scheme.

Next Steps in the Madoff Fallout

At present, several investors have filed a proposed class action lawsuit against Bernard L. Madoff Investment Securities, which seeks as much as $100 million lost by five investors. The proposed class of investors could swell to more than 1,000. As the case develops into what could be the "largest fraudulent scheme in the history of Wall Street and the United States," investors should be aware that their returns and in some cases, their entire investments, are likely at risk. As such, it is important for investors in Madoff Securities to be aware of fraudulent transfer issues and defenses that may be available once certain inevitable fraudulent transfer claims are filed. Pillsbury Winthrop Shaw Pittman LLP has extensive experience litigating fraudulent transfer claims in the Ponzi scheme context and is available to advise investors of their options in such a scenario.

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