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Allocating Loss in Securities Fraud: Time to Adopt a Uniform Rule for the Special Case of Ponzi Schemes

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

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ABSTRACT

The global financial crisis precipitated a condensing of capital and a fall in global equities markets that not only resulted 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 to finish, it becomes important to clearly identify the methodologies used to value the loss and allocate existing assets among the remaining creditors. To that end, this Article argues 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 make the determination of loss not only considerably easier but also more equitable.

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INTRODUCTION

The impetus of the global financial crisis resulted in the revelation that many of the world's most revered financial institutions were neither properly capitalized nor as well secured as they led investors to believe.[1] In addition to sparking the government bailout of banks, insurance companies, and the auto industry,[2] the devaluation of equities resulted in the discovery[3] of a number of major Ponzi schemes[4] that collectively will cost

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[1] *See, e.g.*, MATHIAS DEWATRIPONT, JEAN-CHARLES ROCHET & JEAN TIROLE, BALANCING THE BANKS: GLOBAL LESSONS FROM THE FINANCIAL CRISIS 14 (Keith Tribe trans., 2010); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED AND WHAT TO DO ABOUT IT 12 (2008).

[2] Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 470 (2010) (discussing the difficult choice between allowing companies to go bankrupt or providing government funds to maintain their solvency); Frederick Tung, *The Great Bailout of 2008–09*, 25 EMORY BANKR. DEV. J. 333, 333–34 (2009) (detailing the acquisition of Bear Stearns, the fall of Lehman Brothers, and government assistance for AIG, Fannie Mae, Freddie Mac, et cetera). *See generally* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283 (2010) (discussing the Troubled Asset Relief Program bailout and its after-effects for the financial and automotive sectors).

[3] An otherwise insolvent Ponzi scheme is able to continue to function as long as it obtains new capital to cover all demands for withdrawal of funds from its creditors. The correction in global economic markets exposed such schemes by increasing the demand for liquidation and withdrawal of capital from nonexistent investments without the infusion of new capital to cover the calls. Unfortunately, it is only in periods of economic correction that the most successful schemes are ultimately exposed. *See* Caitlin Hall, *The Death of a Defense: How Derivatives Spell the End of the Good Faith Defense to Fraudulent Transfer Actions in Business Bankruptcies*, 8 BERKELEY BUS. L.J. 152, 161 (2011) ("The typical Ponzi Scheme is insolvent from its inception." This is because every investor in a Ponzi scheme becomes at the same time a creditor); *see also* Craig Lutterbein, Note, *"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, 406 (2010) (explaining the insolvency created by Ponzi schemes).

[4] 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 multimillionaire in less than six months by claiming to trade in international postal coupons and promising returns of one hundred percent interest. The subsequent collapse of his fraud, resulting in his immediate 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 COLUM. BUS. L. REV. 657, 673–74 & 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).

investors tens of billions of dollars.[5] These include the Bayou Group LLC,[6] the Tom Petters scheme,[7] Dreier LLP,[8] and the now infamous Bernie Madoff scandal.[9] 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.[10]

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[11] and the promulgation of new rules by regulators—both national and international—designed to improve the transparency of the global financial system.[12] Other proposals

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[5] *See, e.g.*, David A. Gradwohl & Karin Corbett, *Equity Receiverships for Ponzi Schemes*, 34 SETON HALL LEGIS. J. 181, 182 (2010) (noting that the loss to innocent investors in the Madoff scheme alone was more than fifty billion dollars).

[6] Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (*In re* Bayou Group, LLC), 439 B.R. 284, 328 (Bankr. S.D.N.Y. 2010) (reversing a previous default judgment and ordering claims to proceed to trial); Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 823 (Bankr. S.D.N.Y. 2008) (involving the loss of more than $250 million in principal to investors in a fraudulent hedge fund operation).

[7] United States v. Petters, No. 08-5348 ADM/JSM, 2009 WL 803482, at *1 (D. Minn. Mar. 25, 2009) (providing background on the criminal case against Petters, who is accused of bilking investors out of more than three billion dollars); *see also In re* Petters Co., 425 B.R. 534, 538 (Bankr. D. Minn. 2010) (noting that the bankruptcy trustee appointed in the Chapter 11 proceedings will continue to serve as trustee for all investors and be charged with creating a plan for the court's approval to recover, allocate, and distribute remaining assets).

[8] United States v. Dreier, 682 F. Supp. 2d 417 (S.D.N.Y. 2010) (criminal case); *In re* Dreier LLP, 429 B.R. 112, 120 (Bankr. S.D.N.Y. 2010) (civil suit by creditors against Dreier's bankrupt estate, wherein the total loss was approximately thirty million dollars).

[9] United States v. Madoff, 586 F. Supp. 2d 240 (S.D.N.Y. 2009) (criminal case); SEC v. Madoff, No. 08 Civ. 10791 (LLS), 2009 WL 721712, at *1 (S.D.N.Y. Feb. 9, 2009) (noting that the total loss to all investors could be as much as fifty billion dollars). *See generally* Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221 (2009) (analyzing clawbacks through a case study of the Bernard Madoff litigation).

[10] *See* sources cited *supra* notes 6–9.

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[12] The new banking rules, now known as Basel III, are perhaps the most obvious change to the international financial system in response to the economic crisis. For a discussion of those rules approved by the G-20 and a summary of what they may mean for the global financial system, see Jack Ewing, *Special Report: Davos 2011; Few Signs of United Approach to Financial Regulation*, N.Y. TIMES, Jan. 28, 2011, at B5. For a discussion of how effectively domestic and international financial regulatory institutions work together, with some consideration of the implementation of the Basel III rules, see

would go even further.[13] While the courts battle over the remaining assets—which by the very nature of the fraud are substantially smaller than the principal that creditors extended to the schemes—and regulators 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 and who are largely equally innocent. Should all investors bear the costs of fraud equally? Ought those with security interests be better protected by the courts and be the first to take from among the remaining assets? Is it equitable if, after secured interests are distributed, there is virtually nothing left for the unsecured creditors? What if the remaining assets amount to even less than 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?[14] 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,[15] final determination by the Supreme Court itself.[16]

To that end, this Article sets out the various methods of determining the recoverable loss of each party, and argues that the most equitable solution is grounded on principles founded in civil law, but refined and developed in the criminal prosecution of Ponzi scheme operators. Known alternately as the "rescission and restitution method,"[17] or "the loss to losing

generally Daniel Hemel, Note, *Regulatory Consolidation and Cross-Border Coordination: Challenging the Conventional Wisdom*, 28 YALE J. ON REG. 213 (2011).

[13] *See, e.g.*, Ponzi Scheme Investor Protection Act of 2010, H.R. 5032, 111th Cong. (2010) (seeking to "provide insurance coverage for certain indirect investors caught in Ponzi schemes").

[14] *See* Lutterbein, *supra* note 3, at 406.

[15] A split is already emerging between the use of the net investment method favored by the Second Circuit, the rescission and restitution method popularized by the Ninth Circuit, and the loss to the losing victim method promulgated by the Eighth Circuit. Each method is defined and evaluated in Part III of this Article, *infra*.

[16] The Supreme Court's docket is largely discretionary. One of the most important factors for whether the Court will agree to hear a case is whether a split exists among federal appellate courts. *See* SUP. CT. R. 10(a) ("[A] United States court of appeals has entered a decision in conflict with the decision of another United States court of appeals on the same important matter.").

[17] Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 706 (9th Cir. 2008) ("[T]he 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

victims method,"[18] this principle of allocating loss accurately compensates all parties for the actual and realized losses they have sustained, without the unfairness that is endemic in other methodologies, particularly the recently popular "net investment approach."[19] 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 with which the Ponzi scheme operator is charged in the criminal proceedings.

Part I of this Article lays out the standard of review used by appellate courts and the wide latitude district courts receive 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.

Part II looks at the different kinds of creditor victims of 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 indeed ought to recover the full amount of their secured interest before unsecured creditors are allowed to recover 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 Ponzi scheme operator can offer secured positions for every new investor for very long without the scheme being discovered.[20] Therefore, incentiv-

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Energy Corp., 944 F.3d 589, 596 (9th Cir. 1991))); Jobin v. McKay (*In re* M & L Bus. Machine Co.), 84 F.3d 1330, 1341 (10th Cir. 1996) ("[I]nvestors in a fraudulent scheme clearly had claims for rescission and restitution ... regardless of whether there existed a contractual right to the return of principal." (citing *United Energy*, 944 F.3d at 596)).

[18] United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996) (internal quotation marks omitted). The proper focus is on the amount of loss for a particular victim. *See id.* (holding that, in calculating loss from a Ponzi scheme, the district court correctly calculated the loss to the scheme's victims by using the net loss to the losing victims method); United States v. Mount, 966 F.2d 262, 265 (7th Cir. 1992) ("[A] fraud that consists in promising 20 ounces of gold but delivering only 10 produces as loss the value of 10 ounces of gold, not 20.").

[19] *See infra* Part III.A.

[20] 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.

izing secured positions makes it more likely that a fraudulent scheme will be uncovered more quickly.

Part III 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 with a discussion of the net investment approach, which is currently the most commonly used rule,[21] and moves on to discuss two alternate approaches: (1) rescission and restitution and (2) the loss to the losing victim. Derived alternately from civil and criminal law, these allocation methods assign loss differently from the net investment approach and are indeed preferable for the unique case of Ponzi schemes. While the difference in calculating loss between rescission and restitution and the loss to the losing victim is de minimis, the policy justifications for each are unique. This Article takes the definite position that the better thought-out approach originates in criminal law and is now found in the loss to the losing victim method.

Finally, Part IV makes the case that, when deciding between the different principles articulated by the loss allocation rules, courts must consider the nature of a Ponzi scheme before selecting an allocation method. Although 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.

I. COURTS HAVE DISCRETION TO DETERMINE ALLOCATION

Ponzi schemes are a unique kind of fraud with four basic elements: (1) capital infusion from investors, (2) the fraud itself, (3) payments to investors that necessitate ever-increasing new investment to perpetuate the fraud, and (4) "absurdly and unbelievably high" rates of return that induce investment.[22] The scope of the fraud can cover a myriad of industries,[23]

[21] *See infra* note 73 and accompanying text.

[22] Paul W. Bonapfel, William Hicks, John Mills & Todd Neilson, *The Business Bankruptcy Panel Ponzi Schemes—Bankruptcy Court v. Federal Court Equity Receivership*, 26 EMORY BANKR. DEV. J. 207, 207 (2010).

[23] *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." (quoting William Hicks, U.S. Securities and Exchange Commission)).

but it always involves the Ponzi scheme operator asserting that the investor's capital is being used to generate the profit the returns are predicated upon, when in reality the capital is being used to pay investors the false return on their investment. This induces new investment while permitting the Ponzi scheme operator to misappropriate millions of other people's dollars.[24]

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.[25] 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.[26] The receiver, not the court, is the body that ultimately makes payments to claimants.[27] This often leads to the common misperception that it is the receiver, not the court, which is 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.[28] It is the court, not the receiver[29] or state law,[30] which governs allocation. This makes the receiver an officer of the court, not an independent agent;[31] although the receiver

[24] Lutterbein, *supra* note 3, at 406 ("In Ponzi schemes, early investors are simply paid from the investments of later investors.").

[25] SEC v. Presto Telecom., Inc., 153 F. App'x 428, 430 (9th Cir. 2005) ("The district court did not abuse its discretion by invoking its inherent equitable power to appoint a receiver."); SEC v. Wencke, 622 F.2d 1363, 1369 (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.").

[26] GARRARD GLENN, THE LAW GOVERNING LIQUIDATION § 312 (1935).

[27] *See* Crites, Inc. v. Prudential Ins. Co. of Am., 322 U.S. 408, 414 (1944).

[28] 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.'" (quoting SEC v. Hardy, 803 F.2d 1034, 1037 (9th Cir. 1986))); *see also* SEC v. Pension Fund of Am. L.C., 377 F. App'x 957, 961 (11th Cir. 2010).

[29] N. Am. Broad., LLC v. United States, 306 F. App'x 371, 373 (9th Cir. 2008).

[30] Dzikowski v. N. Trust Bank of Fla., N.A. (*In re* Prudential of Fla. Leasing, Inc.), 478 F.3d 1291, 1295 (11th Cir. 2007) ("[T]he 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.").

[31] *N. Am. Broad., LLC*, 306 F. App'x at 373 ("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

may issue preliminary findings or recommendations regarding the methods of determination and allocation of loss,[32] the court is the agent that ultimately reviews and ratifies the receiver's actions.[33] 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 scheme operator without the court's ratification of the allocation scheme.[34] In practice, Ponzi schemes are notoriously complex and often involve hundreds of thousands of pages of discovery.[35] The receiver may also be working with or fighting against a federal prosecutor who is tasked with bringing criminal charges against the accused. At the same time, the receiver is managing the bankruptcy and the court is handling a bevy of civil suits.[36] The receiver is accordingly in the best position to hear the arguments made by all parties, to ascertain the specific losses claimed by each creditor, and to try to reconcile these demands with the remaining or foreseeably recoverable assets. The receiver's recommendation to the court regarding the appropriate method of allocating loss among equally innocent parties is therefore given considerable weight when a court is reviewing whether to approve the proposed allocation.[37]

A district court's decision concerning the supervision of an equitable receivership is reviewed only for abuse of discretion.[38] The basis for this

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order of his appointment and the course and practice of the court." (citing Booth v. Clark, 58 U.S. 322, 331 (1854))).

[32] *Id.*

[33] Crites, Inc. v. Prudential Ins. Co. of Am., 322 U.S. 408, 414 (1944) (holding that a receiver "was ... 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, 217–18 (1872).

[34] *See Davis*, 83 U.S. at 218.

[35] *See Ponzi Schemes*, PARKMAN, ADAMS & WHITE, http://www.parkmanlawfirm.com/practice-areas/ponzi-schemes (last visited Mar. 25, 2012).

[36] *See, e.g.*, United States v. Dreier, 682 F. Supp. 2d 417 (S.D.N.Y. 2010) (criminal case); *In re* Dreier, LLP, 429 B.R. 112 (Bankr. S.D.N.Y. 2010) (civil suit) (illustrating a criminal and civil suit proceeding simultaneously for the same Ponzi scheme).

[37] SEC v. Byers, 637 F. Supp. 2d 166, 175 (2009) (noting that the court "give[s] weight to the Receiver's judgment").

[38] SEC v. Loving Spirit Found., Inc., 392 F.3d 486, 490 (D.C. Cir. 2004) ("[T]he district court exercised its 'extremely broad' supervisory power over an ongoing receivership." (quoting SEC v. Hardy, 803 F.2d 1034, 1037 (9th Cir. 1986))); SEC v. Lincoln Thrift Ass'n, 577 F.2d 600, 606–09 (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 Fin. Serv., Inc., 674 F.2d 368, 372–73 (5th Cir. 1982); SEC v. An-Car Oil Co., 604 F.2d 114, 119 (1st Cir.

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, so an appellate court need not interfere in the minutiae of ongoing proceedings once the case has been managed, first by the receiver and then by a trial court.[39] 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, and 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.[40] 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 (both time and expense) that would have to be expended if review approached a de novo standard. As a corollary, district courts have a great deal of leeway when it comes to ratifying different methods to determine loss and allocate assets.[41] Confident that the standard of review is broad enough to permit them to independently evaluate the parties and the facts to determine the most equitable methodology to allocate loss without concerning themselves with the possibility of being overturned on appeal, trial courts have not settled on a single predictable and uniform rule for allocation that would protect the reasonable expectations of all parties. Rather, courts have adopted a variety of methods to allocate loss based on the facts of each case.[42]

The lack of discipline by district courts to use a single method is problematic, achieving neither the predictability nor the uniformity of result

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1979) ("[O]ur review is limited to determining whether [the court's broad range of] discretion has been abused.").

[39] SEC v. Hardy, 803 F.2d 1034, 1037 (9th Cir. 1986) (noting that "a court overseeing a receivership is accorded 'wide discretionary powers' in light of 'the concern for orderly administration'" (quoting *Safety Fin. Serv. Inc.*, 674 F.2d at 373)).

[40] A list of victims of the Bernie Madoff Ponzi scheme numbered more than 13,500 accounts. *See* Duncan Greenburg & Matthew Miller, *The Madoff Ponzi: Madoff's Billionaire Victims*, FORBES (Feb. 5, 2009), http://www.forbes.com/2009/02/05/bernard-madoff-billionaires-business-billionaires-0205_madoff.html (noting, however, that "the number of [individual] people Madoff defrauded is likely less than that because many victims held several accounts with his firm").

[41] United States v. Kumar, 617 F.3d 612, 632 (2010).

[42] These include the net investment method, the rescission and restitution method, and the loss to the losing victim method. Each of these methods, and their comparative merits, are discussed further *infra* Parts III.A–C, respectively.

that parties expect from bankruptcy courts. A failure to settle upon a single loss allocation rule disrupts the reasonable expectations of future creditors and may hinder investment in perfectly legitimate businesses. Serious problems arise when determining valuation because different receivers propose different methods of allocating loss among potential creditors. When the courts affirm these various methods, it creates a patchwork of diverse methodologies, with virtually no criterion to choose between the various allocation calculations.[43] Receivers, creditors, and the financial system as a whole would benefit from rules so clearly articulated as to approach a single standard method of determining loss in situations of securities fraud. For reasons provided in Parts III and IV of this Article, that allocation rule ought to be the loss to the losing victim method.

II. SECURED VERSUS 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;[44] however, there is an open question regarding which parties are properly termed "similarly situated." While there can be no doubt that superficial differences[45] do not justify special treatment, whether a party is a secured creditor does justify distinct treatment for purposes of allocation of recovery.

The law has long distinguished secured from unsecured claimants: "[A]ll creditors similarly situated are treated equally; secured creditors are given advantages that unsecured creditors do not have."[46] The Supreme

[43] 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, these advantages are dwarfed by the inefficiency and uncertainty ultimately created. What results is a nearly endless appeal process on the question of validation, which slows liquidation and distribution, and is accordingly inequitable and inefficient.

[44] Till v. SCS Credit Corp., 541 U.S. 465, 477 (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." (footnote omitted)).

[45] Examples of such superficial differences 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, et cetera.

[46] *In re* Nixon, 34 F.2d 667, 669 (N.D. Okla. 1929).

Court agrees.[47] 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 than unsecured creditors.[48]

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.[49] 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."[50] 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.[51] These individuals have a claim 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.[52] Finally, they are also incentivized to work together to find all possible assets, whether secured or unsecured,

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[47] *Till*, 541 U.S. at 477 n.16; *see also id.* at 504 n.15 (Scalia, J., dissenting) (distinguishing between secured and unsecured creditors as fundamentally different classes of creditors in a bankruptcy).

[48] Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: An Overview and Insolvency Perspective*, 29 CAL. BANKR. J. 213, 242–43 (2007) (discussing the different rights of secured and unsecured creditors).

[49] 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.").

[50] Geoffrey C. Hazard, Jr., John L. Gedid & Stephen Sowle, *An Historical Analysis of the Binding Effect of Class Suits*, 146 U. PA. L. REV. 1849, 1891 (1998) ("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.").

[51] Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 971 (2009) (discussing indirect victims of a Ponzi scheme who are "individual clients of feeder funds" which invested clients' funds into the fraudulent scheme).

[52] *Id.* (noting that the feeder fund may be compensated as any other victim of the Ponzi scheme, and "indirect investors have the ability to sue the fund in which they invested for fraud or negligence").

because this will increase the ultimate size of the pool of assets for all claimants.[53]

Treating secured and unsecured creditors separately also provides all parties with the benefit of their bargain.[54] 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."[55] While there have been instances when 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,[56] and denied preferential treatment when the claimant had already been made whole,[57] there are no instances of a court treating a properly secured creditor and unsecured creditor as similarly situated victims of a Ponzi scheme.[58]

Certainly, there are occasions where the amount of recovered capital is less than the total secured claims of creditors.[59] In these instances, the unsecured creditors, while not legally barred from recovery, will function-

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[53] Hazard, Gedid & Sowle, *supra* note 50, at 1891.

[54] *In re* Moulton Excavating, 143 B.R. 955, 956 (Bankr. D. Utah 1992) (stating that secured creditors should not be "deprived of the benefit of their bargain").

[55] *In re* Berry Good LLC, 400 B.R. 741, 746 (Bankr. D. Ariz. 2008).

[56] Corporate Fin., Inc. v. Fidelity Nat'l Title Ins. Co. of N.Y. (*In re* Corporate Fin., Inc.), 221 B.R. 671, 677 (Bankr. E.D.N.Y. 1998) (finding that the initial investors were not treated as secured creditors because "the mortgage loans to which they contributed were not properly recorded," and also finding that the mortgages were secured for a group of investors through the scheme, thus making the investors not direct participants in the mortgage transaction and therefore not entitling them to a secured position).

[57] First Am. Title Ins. v. Countrywide Home Loans, No. 27-CV-05-7830 (Minn. State Dist., Feb. 15, 2007) (recognizing different 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).

[58] Dana Yankowitz, Comment, *"I Could Have Exempted It Anyway": Can a Trustee Avoid a Debtor's Prepetition Transfer of Exemptible Property?*, 23 EMORY BANKR. DEV. J. 217, 223 n.25 (2006) ("The Bankruptcy Code provides payment to creditors based on classification of their claims. *See* [11 U.S.C.] § 1129(a)(7)–(8) [2000]. '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.'" (quoting Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 283, 326 n.11 (2004))).

[59] *See* RAYMOND T. NIMMER, INGRID MICHELSEN HILLINGER & MICHAEL G. HILLINGER, COMMERCIAL TRANSACTIONS: CASES, MATERIALS, PROBLEMS 18 (3d ed. 2003).

ally recover nothing because they take only after the secured claims have been satisfied.[60] This result, however inequitable it may appear on its face, is a logical construction of existing bankruptcy and securities law.[61] It has the added benefit of being both predictable and uniform: sophisticated and unsophisticated creditors alike recognize that a security interest (like a lien or a mortgage) confers special and specific rights to recover value placed in a particular asset.[62] The option of perfecting a security interest is available to all parties equally, and so upholding the secured interest is ultimately fair.[63]

Moreover, where assets subject to a security interest in a Ponzi scheme have been liquidated for more than the value of the security, the difference between the sale price and the amount of the security is returned to the pool to be allocated among all unsecured claims.[64] When the assets are sold for less than the value of the security interest, the secured party can preferentially take only the amount realized by the sale of the specific and securitized asset, with the difference being rolled over into the secured party's claim from the unsecured pool of funds.[65] Accordingly, giving credence to security interests does not allow secured creditors to unfairly pilfer funds from the larger pool of monies set aside for allocation among unsecured creditors, and may even help contribute excess value.[66]

Giving equally innocent secured creditors the benefit of their bargain is particularly justifiable in instances of securities fraud. Because the as-

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[60] *Id.* at 20 (noting that an unsecured creditor's "claim will be satisfied only if and to the extent value remains after the secured creditor's claim is satisfied in full").

[61] *Id.* at 21–25 (discussing the theory behind secured credit).

[62] *See id.*

[63] *See, e.g.*, OHIO REV. CODE ANN. §§ 1309.301–.342 (2011); VA. CODE ANN. §§ 8.9A-301 to -342 (2011) (stating the statutory requirements and processes for perfecting a security interest; notably absent is any language restricting perfection to particular parties).

[64] NIMMER, HILLINGER & HILLINGER, *supra* note 59, at 20.

[65] Kenneth C. Johnston, Kellie M. Johnson & Joseph A. Hummel, *Ponzi Schemes and Litigation Risks: What Every Financial Services Company Should Know*, 14 N.C. BANKING INST. 29, 50 (2010) (discussing the principle that from a secured interest, the creditor is not entitled to more than the value of her or his security interest when a Ponzi scheme is being liquidated and distributed: "contracts arising from a Ponzi scheme are 'unenforceable to the extent they purport to give persons a right to payments in excess of their initial undertaking'" (quoting SEC v. Madison Real Estate Grp., LLC, 647 F. Supp. 2d 1271, 1280 (D. Utah 2009))).

[66] The demand by a creditor for a security interest in real assets from the operator of a Ponzi scheme increases the likelihood of discovering the scheme. *See supra* note 20 and accompanying text. Where perfecting a security interest does not uncover a scheme, it almost certainly forces the operator to park some assets in real or tangible property and thus increases the amount of fixed assets that can ultimately be recovered.

sets of a Ponzi scheme are limited by the investment put in by prior creditors, a Ponzi scheme operator cannot offer every party a secured interest in the full value of their investment for very long without the nature of the fraudulent scheme becoming uncovered by savvy investors, title companies, or the financial system.[67] Therefore, incentivizing behavior that encourages parties to obtain secured positions is a legitimate means of policing Ponzi operations.

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.[68] 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.

III. THE MAJOR APPROACHES

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.[69] While there are sel-

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[67] *See supra* note 20 (providing a brief discussion of this proposition).

[68] 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. *See* Yankowitz, *supra* note 58, at 223 n.25.

[69] *See* 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, 1350 (2010) (describing the "pro rata rule for Ponzi schemes: '[I]n the case of a Ponzi scheme, remaining assets must be distributed to victims on a pro-rata basis *unless* a particular [claimant's] assets are able to be specifically traced.'" (quoting Adams v. Moriarty, 127 P.3d 621, 624 (Okla. Civ. App. 2005))); *see also* 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

dom 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,[70] 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.[71]

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,[72] it is necessary to explore the divergences between the approaches. After reviewing the more commonly applied net investment approach, this Article will posit two alternatives that 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—the loss to the losing victim—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.[73] It stands for the basic propo-

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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.").

[70] *See supra* note 41 and accompanying text.

[71] *See supra* note 38 and accompanying text. Because courts have found any number of allocation systems to be reasonable, it is considerably harder to prevail upon appeal when the standard of review 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.

[72] CFTC v. Topworth Int'l, 205 F.3d 1107, 1116 (9th Cir. 1999) (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).

[73] Paul Sinclair & Brendan McPherson, *The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part IV*, AM. BANKR. INST. J. 70 (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

sition that "equality is equity,"[74] 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 of investment.[75] 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.[76] In fact, any overpayment made in the guise of "interest" or "return of principal" beyond that which was initially invested is eligible for reclamation.[77]

Under the net investment approach, an individual creditor's loss is measured by first taking all of the funds loaned out to the Ponzi scheme operator from the innocent investor.[78] Then, assuming that because the scheme did not 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 amount the creditor loaned out, functionally an investment at zero percent interest.[79] Accordingly, the net investment approach assumes that any return on investment is the repayment of principal, or

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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. *See* Sec. Inv. Prot. Corp. v. Madoff Inv. Sec. (*In re* Madoff), 429 B.R. 423, 427 (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 ... account, less any amounts withdrawn from the customer's ... account (the 'Net Investment Method').").

[74] Cunningham v. Brown, 265 U.S. 1, 13 (1924).

[75] CFTC v. Equity Fin. Grp., LLC, No. Civ.04-1512 RBK AMD, 2005 WL 2143975, at *22 (D.N.J. Sept. 2, 2005) (noting that the "[r]ecovery of both 'profits' and the original investment is deemed inequitable under this theory, as a claimant's original investment would be repaid at the expense of equally innocent later investors" (citing *In re* Tedlock Cattle Co., 552 F.2d 1351, 1352–53 (9th Cir. 1977))).

[76] *Cunningham*, 265 U.S. at 13.

[77] *See infra* note 141 and accompanying text.

[78] *See* 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).").

[79] *See In re* New Times Sec. Servs., Inc., 371 F.3d 68, 74 (2d 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 (*In re* Old Naples Sec., Inc.), 311 B.R. 607, 617 (M.D. Fla. 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.").

perhaps more accurately, a repayment of interest at zero percent with all payments in excess of the interest payment credited toward a repayment on principal.[80] Thus, when a court uses the net investment approach 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 principal 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 principal.[81]

The final calculation of the net investment approach is thus measured by a combination of dollars in versus dollars out.[82] If the end result is that the creditor received more return from the scheme (dollars in) 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 responsible for the return of funds.[83] Even less equitably, if the amount returned to the creditor is less than the amount paid into the scheme, but more than the creditor's pro rata share of the remaining assets,

[80] SEC v. Byers, 637 F. Supp. 2d 166, 176 (S.D.N.Y. 2009) ("[I]t is important to remember that each investor's recovery comes at the expense of others."); *Focht*, 311 B.R. at 617 ("No one disputes that the interest payments were not in fact interest at all, but were merely portions of other victims' capital investments.").

[81] *See Capital Consultants*, 397 F.3d at 737 n.5 (finding that the net investment approach concludes that "all principal paydowns, interest payments, or other payments in funds, securities, or other property credited to a client's account" shall be determined to be repayments of principal); *see also* Sinclair & McPherson, *supra* note 73, at 70 (discussing the policy arguments against the principle that "equality 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 *infra* Parts III.B–C.

[82] Sender v. Bronze Grp., Ltd., 380 F.3d 1292, 1296 (10th Cir. 2004) (noting that the net investment approach determines loss by looking strictly at the "cash-in, cash-out" history of transactions and then allocating loss among all investors in the same class on a strictly pro rata basis); CFTC v. Equity Fin. Grp., No. Civ.04-1512-RBK-AMD, 2005 WL 2143975, at *22–24 (D.N.J. 2005) (holding that the equities approach to allocating loss in the case of a Ponzi scheme required the use of the cash-in cash-out evaluation of each innocent investor's account, followed by a pro rata allocation of remaining assets); Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard Madoff Inv. Sec. LLC), 424 B.R. 122, 134–35 (Bankr. S.D.N.Y. 2010) (finding that the cash-in cash-out allocation method would be used to allocate loss among investors in the Madoff Ponzi scheme).

[83] Hurt, *supra* note 51, at 971 & n.144 (noting that 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 the Ponzi scheme under authority of 15 U.S.C. § 78fff-2(c)(3) (2006)).

that difference may also be "clawed back" by the receiver.[84] 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.[85] Under this supposedly equitable approach, investors are not given the benefit of their bargains, but are all forced to share equally in the losses of the scheme.[86]

The net investment approach is the most common method that courts have used to allocate loss among parties in cases of securities fraud.[87] 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 principal or payments of interest on principal invested.[88]

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 as equally innocent as the last investor, loses considerably more.[89] Other equitable considerations concern the loss of the investors' benefit of their bargain, and confounding the rational expectations of all parties involved.[90] A more thorough discussion of the failures of the net investment approach can be found *infra* Part IV.

To rectify the many problems associated with the net investment approach, this Article proposes that, for the special case of Ponzi schemes, federal courts 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: the rescission and restitution method or the loss to the losing victim method.

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[84] *Id.* at 972 n.145.

[85] *See supra* note 81 and accompanying text (discussing the pro rata allocation requirements under the net investment approach).

[86] *In re* Tedlock Cattle Co., 552 F.2d 1351, 1352 (9th Cir. 1977) ("Under the equity theory, no investor creditor will receive the benefit of his bargain, but all will share some recovery.").

[87] Sinclair & McPherson, *supra* note 73, at 68.

[88] *Id.* at 68–69.

[89] *See infra* notes 126–27 and accompanying text.

[90] *See* United States v. Holiusa, 13 F.3d 1043, 1048 (7th Cir. 1994) (Manion, J., dissenting) (disagreeing with the court's adoption of a "net loss" approach and stating that "[t]he only 'security' the[] investors had was [the Ponzi scheme operator's] need to periodically transfer some money back in order to con the investors into thinking they were getting a good return on their money.").

B. Rescission and Restitution Method

The rescission and restitution method of allocating the loss of individual innocent lenders in a Ponzi scheme is taken from principles of both contract law and equity.[91] It does not intend to discount or reduce the total loss as much as possible (which is too often the result of the net investment approach), but instead aims to compensate parties based upon their realized loss.[92] It is calculated by taking the principal that each lender was induced to provide to the Ponzi scheme operator, and then subsequently reducing that amount by the return of all principal.[93] Different variations on its calculation alternately account dividend reinvestment as principal or interest—a determination that is made by the court, and based upon the specific facts of each case and the appropriateness of its inclusion given the standard business practice of the scheme.[94] It notably excludes a reduc-

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[91] Andrew Kull, *Rescission and Restitution*, 61 BUS. LAW. 569, 570 (2006) [hereinafter Kull, *Rescission and Restitution*] ("This primary ambiguity is frequently observable 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, *Rationalizing Restitution*, 83 CALIF. L. REV. 1191, 1219 (1995) [hereinafter Kull, *Rationalizing Restitution*] ("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." (footnote omitted)).

[92] *See* CFTC v. Richwell Int'l, Ltd., 163 B.R. 161, 162–63 (N.D. Cal. 1994) (deciding to employ a rescission and restitution plan in order to pay victims "in proportion to their total lost money"); *In re* Trending Cycles for Commodities, Inc., 27 B.R. 709, 710 (Bankr. S.D. Fla. 1983) (approving a plan under the rescission and restitution formula that was "equal to the total out-of-pocket deposit made by a customer minus withdrawals"); *see also* Kull, *Rescission and Restitution*, *supra* note 91, at 576 (describing restitution as a way to "restore to the injured party something previously given to the defendant by way of performance, or ... restore the injured party to the precontractual status quo, or ... do both of these things at once").

[93] *Richwell*, 163 B.R. at 162–63. 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. *Richwell* is clear that after the total loss is determined, the remaining assets are allocated pro rata under the rescission and restitution approach. *Id.* ("[D]istribute the remaining general property to both past and present customers *pro rata* under a rescission and restitution formula, paying them in proportion to their total lost money.").

[94] *In re* New Times Sec. Servs., Inc., 371 F.3d 68, 79–80 (2d Cir. 2004). A court applying the rescission and restitution method may determine on a case-by-case basis

tion in the amount returned as interest.[95] Using this method, the aggregate amount of loss will be significantly greater, because no discount is given for the return of interest.[96] However, because allocation of loss is pro rata, each creditor is still returned the proportional share of loss that he or she is entitled to, without sacrificing contract principles or the expectation of each individual creditor.[97] 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 that the scheme was fraudulent.[98]

The most commonly cited case in favor of the rescission and restitution approach is *Commodities Futures Trading Commission v. Richwell International Ltd.*[99] In *Richwell*, the District Court for the Northern District of California 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 principal as their loss.[100] The court considered other approaches, but determined that accounting for the realized gains of some parties would legitimize the illegal operation,[101] that recovering based upon actualized loss better tracked creditor expectations than reduc-

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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 principal for the purpose of allocating loss among innocent investors. *See id.* at 71 ("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).").

[95] *See* Kull, *Rescission and Restitution*, *supra* note 91, at 576 (explaining that the important difference between the net investment approach and the rescission and restitution approach is that while the former discounts the principal deposits by a return on principal and interest, the latter only discounts the loss by the amount of the original deposit that has been returned as principal).

[96] *In re New Times Sec. Servs., Inc.*, 371 F.3d at 88 (discussing use of the rescission and restitution method and taking out the "artificial interest" and "dividend reinvestments" shown in "fictitious account statements" created by the Ponzi scheme operator).

[97] *See* Kull, *Rescission and Restitution*, *supra* note 91, at 577 (discussing the use of rescission as a natural remedy of a breach of contract).

[98] 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 profits. Scholes v. Lehman, 56 F.3d 750, 760 (7th Cir. 1995). Judge Posner reminds us all that if something sounds too good to be true, it probably is. *Id.*

[99] CFTC v. Richwell Int'l, Ltd., 163 B.R. 161 (N.D. Cal. 1994).

[100] *Id.* at 164.

[101] *Id.* at 163 ("[T]o impose a constructive trust on specific assets for specific customers, at the expense of other similarly situated customers, would be inequitable.").

ing the loss by any realized gains,[102] and that equity demanded a scheme that accounted for the principal.[103]

The rescission and restitution method has received support beyond the District Court for the Northern District of California, perhaps most notably from the Securities Investor Protection Corporation (SIPC). The SIPC 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.[104] The SIPC[105] was created in response to a federal mandate in the Securities Investor Protection Act,[106] and exists to protect investors in the event of a brokerage failure.[107] 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 *Richwell* approach, the principal of each creditor's initial loan is used to determine their realized loss and, accordingly, their proportion of recovered assets.[108] Transactions in a Ponzi scheme are often much closer to that of a lender-borrower relationship than a purely speculative

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[102] *Id.* at 164 ("[T]hose who are victims of theft or fraud expect to receive their property back if it is possible to actually identify what property is theirs.").

[103] *Id.* at 162 & n.1 (noting that 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[]"; the court noted 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).

[104] Sinclair & McPherson, *supra* note 73, at 69 & n.51 ("'[R]easonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional reality.'" (quoting Brief of Appellant SIPC at 23–24, *In re* New Times Sec. Servs., Inc., 463 F.3d 125 (2d Cir. 2006) (No. 05-5527-bk), 2005 WL 5338148)).

[105] Congress mandated SIPC to be a non-profit watchdog 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. *See The SIPC Mission*, SECS. INVESTOR PROT. CORP., http://www.sipc.org/who/sipcmission.html (last visited Mar. 25, 2012).

[106] 15 U.S.C. § 78ccc (2006).

[107] SECURITIES INVESTOR PROTECTION CORPORATION, HOW SIPC PROTECTS *YOU*: UNDERSTANDING THE SECURITIES INVESTOR PROTECTION CORPORATION (2011), *available at* http://www.sipc.org/pdf/HSPY_English_2011.pdf.

[108] *See Richwell*, 163 B.R. at 162 (stating that recovery is based upon "net deposits"); *see also In re* Trending Cycles for Commodities, Inc., 27 B.R. 709, 710 (Bankr. S.D. Fla. 1983) (indicating that recovery is based upon the total deposits minus any withdrawals).

equities investor.[109] Innocent creditors are often convinced that they are providing funds for business expansion and development rather than speculating in foreign currencies, stocks, or the bond market.[110] 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.[111] The court in *Richwell* also concluded that focusing on anything but the principal loaned and the repayment of principal received would be contrary to "public policy," because it would give the "appearance of legitimacy" to the otherwise fraudulent transaction.[112] Finally, use of the rescission and restitution method ensures equity is achieved better than use of the net investment approach by indexing the proportion of recovery of each party to the proportion of dollars initially invested, thus giving each party the benefit of his or her bargain: "[T]hose who are victims of theft or fraud expect to receive their property back if it is possible to actually identify what property is theirs."[113]

C. Loss to the Losing Victim Method

Like the rescission and restitution method that originated as an equitable alternative to the net investment approach,[114] 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 reducing those losses when appropriate.[115]

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[109] Paul Davidson, *Is the Current Financial Distress Caused by the Subprime Mortgage Crisis a Minsky Moment? Or Is It the Result of Attempting to Securitize Illiquid Noncommercial Mortgage Loans?*, 30 J. POST KEYNESIAN ECON. 669, 673 (2008).

[110] For example, 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. *See In re* Petters Co., 425 B.R. 534, 542 (Bankr. D. Minn. 2010).

[111] *Richwell*, 163 B.R. at 163.

[112] *Id.*; *see also id.* at 164 ("[U]ltimately the [rescission and restitution method] effects the most equitable compromise. It tracks investor expectations without legitimizing the trading operation by recognizing profits ....").

[113] *Id.*

[114] *Id.* at 162–63.

[115] United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996).

Circuit courts have recognized that Ponzi schemes are a unique kind of fraud,[116] one in which "any gain realized by an individual investor is designed to lure others into the fraudulent scheme."[117] Ponzi scheme operators do not provide investors with gains out of the goodness of their hearts or to lessen damage to investors, but do so to keep their fraudulent schemes running.[118] "[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."[119] Accordingly, the loss to the losing victim method holds that "a victim's gains should be used to offset neither losses to another victim nor losses to that same victim later on in the scheme."[120]

The justification for the loss to the losing victim method is to ensure that all parties are entitled to the benefit of their bargain.[121] While the method originated in criminal law to ensure that a Ponzi scheme operator could not unfairly discount payments made to perpetuate the fraud for sentencing purposes, it protects the innocent investor significantly better than the net investment approach.[122] The loss to the losing victim method

[116] *See, e.g.*, *id.* at 333 ("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."); *see also* United States v. Alfonso, 479 F.3d 570, 573 (8th Cir. 2007) (quoting *Orton*, 73 F.3d at 333).

[117] *Alfonso*, 479 F.3d at 572; *see also Orton*, 73 F.3d at 334 ("Indeed, the very nature of the scheme contemplates payments to earlier victims in order to sustain and conceal the fraudulent conduct.").

[118] *See, e.g.*, *Alfonso*, 479 F.3d 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.").

[119] *Id.* at 572–73.

[120] *Id.* at 573; *see also* United States v. Hartstein, 500 F.3d 790, 798 (8th Cir. 2007) (applying the loss to the losing victim method, which "precludes the offsetting of one victim's earlier gains or profits against that same victim's own later losses"); *Orton*, 73 F.3d at 334 ("This [loss to losing victim] 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.").

[121] John D. Cline, *Calculation of Loss Under the Sentencing Guidelines*, 9 GEO. MASON L. REV. 357, 370 (2000) ("In a Ponzi scheme, early investors are repaid to encourage others to invest .... [T]he '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.").

[122] *See* CFTC v. Richwell Int'l, Ltd., 163 B.R. 161, 163 (N.D. Cal. 1994) (accepting the equity argument that calculating each victim's loss based upon the amount invested and discounting only returned principal, not interest, is the most equitable means of

determines the loss of each party by calculating the principal invested and subtracting the principal repaid, thus arriving at every party's real and actual loss.[123] Every dollar repaid against the principal investment reduces the claim of an innocent victim by one dollar.[124] This better meets the expectations of all parties involved who rightly expect that, should something go wrong with the loan, they will be entitled to recover their principal. Under the loss to the losing victim method, no party is entitled to recover against their principal more than they invested, but each party's loss of principal is fully accounted for without complicated formulas like the net investment approach, which discounts the principal to be repaid significantly more against some parties than others in ways that defy equity.[125]

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 invested in the Ponzi scheme. 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 scheme operator uses the principal 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 invested first.[126] Unlike the loss to the

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).

[123] Frank O. Bowman, III, *A Judicious Solution: The Criminal Law Committee Draft Redefinition of the "Loss" Concept in Economic Crime Sentencing*, 9 GEO. MASON L. REV. 451, 480 (2000) [hereinafter Bowman, *A Judicious Solution*] ("In a case involving a fraudulent investment scheme, such as a 'Ponzi scheme,' the loss shall not be reduced by the value of the economic benefit transferred to any investor in the scheme in excess of that investor's principal investment."); Frank O. Bowman, III, *Coping with "Loss": A Re-Examination of Sentencing Federal Economic Crimes Under the Guidelines*, 51 VAND. L. REV. 461, 548 (1998) (describing how a court applied the loss to the losing victim method: "[T]he court added up all the losses to victims who actually suffered losses, but gave credit to the defendant for repayments made to early victims *only to the extent of their original investment*. The court did not credit the defendant for 'interest' payments made to early victims above their original investment. The court stated: '[This method] 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.'").

[124] Bowman, *A Judicious Solution*, *supra* note 123, at 479 n.107.

[125] *See supra* note 123 and accompanying text.

[126] United States v. Alfonso, 479 F.3d 570, 571 (8th Cir. 2007); *see also Richwell*, 163 B.R. at 163 (finding that removing interest from the equation and focusing solely on 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.[127] These innocent parties deserve to recover their principal in the same proportion as investors who arrived later, assuming 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,[128] wherein 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.[129] The first contribution of $36,000 in principal yielded $8,000 in profit.[130] The victim was thus induced to invest an additional $265,000, of which $110,000 in principal was repaid.[131] The Court determined loss by excluding the interest (gain) realized by the innocent victim; it took the $301,000 total principal invested by the innocent victim and subtracted only the $146,000 of principal repaid (as opposed to the net investment method of adding the $8,000 return on the first contribution to the total principal repaid, which would result in total repayment of $154,000).[132] The allocated loss in this instance is $8,000 greater than the loss calculated using the net investment approach.[133] 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 a significant interest payment on the initial amount.[134]

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principal invested minus the principal returned "would be most equitable in spreading the losses amongst current and former customers .... [B]ecause 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.").

[127] *See, e.g.*, Sender v. C & R Co., 149 B.R. 941, 944–45 (D. Colo. 1992) ("[T]he 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.").

[128] *Alfonso*, 479 F.3d at 571–72 n.3.

[129] *Id.* at 571 n.3.

[130] *Id.*

[131] *Id.*

[132] *Id.* at 571–72 n.3; *see also* United States v. Hartstein, 500 F.3d 790, 798–99 & 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).

[133] *Alfonso*, 479 F.3d at 571–72 n.3; *cf.* United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996) (noting that the "'net loss method' ... ordinarily *underestimates* the loss").

[134] *Alfonso*, 479 F.3d at 572–73.

The loss to the losing victim method has thus far been confined to criminal law, when prosecutors attempt to calculate the total amount of funds misappropriated by Ponzi scheme operators for sentencing purposes.[135] 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.

IV. 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,[136] and a third approach originating in criminal law but providing a reasonable basis and an equitable result if adopted in civil proceedings,[137] this Article will now provide some qualitative analysis 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 the losing victim method. By consistently accounting for the entire value of the principal put up, and reducing that value by any principal returned as dictated by the rescission and restitution and the 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 rescission and restitution and the loss to the losing victim methods, unlike the net investment approach, avoid lengthy and costly litiga-

[135] *See, e.g.*, *Orton*, 73 F.3d at 334 (affirming the sentencing court's use of the loss to the losing victim method).

[136] *See* discussion *supra* Parts III.A–B (discussing the net investment approach and the rescission and restitution approach).

[137] *See* discussion *supra* Part III.C (discussing the loss to the losing victim method); *see also* Cline, *supra* note 121, at 370 ("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.").

tion[138] against innocent parties in an attempt to "claw back" past distributions[139] from wholly innocent investors.[140] In clear contravention of the parties' expectations, the net investment approach would sanction the use of claw back mechanisms in its ultimate defense of "equality is equity."[141] By taking back funds that may have been reinvested or spent by innocent investors who had no knowledge that their gains were derived from fraudulent investments, the net investment approach purports to do the financial system "justice" by properly allocating loss.[142] The reality is much more devastating. While those innocent investors may be able to 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, while still ensuring 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 through the scheme.[143] While prom-

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[138] *See* CFTC v. Richwell Int'l, Ltd., 163 B.R. 161, 164 (N.D. Cal. 1994); Jeffery G. Hamilton & Robert G. Richardson, *Clawback Claims Against Innocent Investors: The SEC vs. The Stanford Receiver*, 28-OCT AM. BANKR. INST. J. 12 (2009) (questioning the reasonability of claw back provisions against innocent investors generally, in cases of Ponzi schemes 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).

[139] Thomas A. Dubbs, *A Scotch Verdict on "Circularity" and Other Issues*, 2009 WISC. L. REV. 455, 457 (2009) (noting that a theory that requires "a 'claw back,' or disgorgement, of gains" recognizes that those gains "are obtained by 'winning' investors who sold their stock in a firm before fraud was disclosed by the firm. [The theory] 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.").

[140] *See* Hurt, *supra* note 51, at 971–72 (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).

[141] *See* Sinclair & McPherson, *supra* note 73, at 69.

[142] *Id.*

[143] Gredd v. Bear, Stearns Sec. Corp. (*In re* Manhattan Inv. Fund, Ltd.), 359 B.R. 510, 523 (Bankr. S.D.N.Y. 2007), *rev'd in part*, 397 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

ised rates of return by some Ponzi scheme operators are so large as to strain credulity, and may in those instances limit the number of innocent creditors,[144] 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.[145] 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.[146] They lose their right to any profits wrongfully acquired and face additional civil as well as criminal penalties.[147]

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.[148] In the aggregate, investors who are diver-

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known in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint.") (internal quotations omitted).

[144] *See, e.g.*, 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 ten to twenty 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.").

[145] *See* Bonapfel, Hicks, Mills & Neilson, *supra* note 22, at 222 ("As to whether or not people knew or should have known, I think in recent times, that has been somewhat mitigated because the investors that I have dealt with in the past two or three years or people that have invested in Ponzi schemes have not gotten exorbitant returns. Some of the earlier ones that I dealt with got crazy types of returns, but the ones now are not getting exorbitant returns.").

[146] *See* 18 U.S.C. § 1956(a)(1) (2006) (permitting fines and imprisonment against anyone who knowingly participates in, profits from, or helps perpetuate fraudulent financial transactions such as Ponzi schemes).

[147] *Id.* § 1956(b)(1).

[148] Janet Cooper Alexander, *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* Donald C. Langevoort, *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) ("[T]he 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

sified, 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.[149] The rescission and restitution and the loss to the losing victim methods accomplish this goal by limiting the receiver's claw back costs to only those investors who were responsible for perpetrating the scheme; the methods are thus targeted to return the largest sums of invested money with the least cost. 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.[150]

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.[151] 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."[152] 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 and the loss to the losing victim approaches are far more equitable than the net investment approach. Functionally, under the net investment approach, 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 earn a return, or discount the value of the dollars invested altogether by essentially

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of these offsetting gains to innocent parties, which the law makes no effort to take away." (footnote omitted)).

[149] Alexander, *supra* note 148, at 1502 ("Some other sanctions regime almost certainly could be better calibrated to achieve those goals, with substantially lower administrative costs.").

[150] CFTC v. Richwell Int'l, Ltd., 163 B.R. 161, 162–63 (N.D. Cal. 1994) (ordering that property be returned to all parties on a pro rata basis based upon the net deposits to the account).

[151] CFTC v. Topworth Int'l, 205 F.3d 1107, 1116 (9th Cir. 1999) (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).

[152] *Id.*

enforcing a loan with no interest, thus depleting the actual and real value of the investment because of the time value of money.[153]

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: "Whatever 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."[154] This principle, when apportioning loss among innocent investors in a Ponzi scheme, is not completely lost today.[155] 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.[156] 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 than under the net investment approach. Assuming the records are reasonably reliable, 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.

CONCLUSION

As a result of the global financial crisis, the next decade will bring with it a significant increase in costly and lengthy litigation to dismantle and return 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 choosing 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.

To reduce costly appeals, conserve judicial resources, and streamline the process of winding down a Ponzi scheme, courts need to implement a

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[153] *See* Sinclair & McPherson, *supra* note 73, at 70 ("[I]t would be inexcusable to adopt a supposedly equitable formula—whe[n] investors ... have invested money with Madoff for years, and some for decades—and to ignore the time value of money.").

[154] Procter & Gamble Distrib. Co. v. Sherman, 2 F.2d 165, 166 (S.D.N.Y. 1924).

[155] Sinclair & McPherson, *supra* note 73, at 70 ("[I]t would be an injustice to ignore '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.'" (quoting *In re* Unified Commercial Capital Inc., 260 B.R. 343, 351 (Bankr. W.D.N.Y. 2001))).

[156] United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996).

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 "equality is equity." To give all equally innocent creditors the benefit of their bargain, courts need to remember that which Judge Learned Hand was prescient to note almost a century ago: time effects the value of money.[157] By moving away from the net investment approach and adopting the rescission and restitution method or the loss to the losing victim method of allocating loss, courts will do a great service to the expectations of all players in the financial system.

[157] *Procter & Gamble*, 2 F.2d at 166.