EQUITY RECEIVERSHIPS FOR PONZI SCHEMES

David A. Gradwohl, Esquire
*Karin Corbett, Esquire**

* Mr. Gradwohl is a partner in the law firm, Fox Rothschild LLP, and Ms. Corbett is an associate. Both practice complex commercial litigation in the Montgomery County office of the firm, and they have been active in cases involving fraud and possible Ponzi schemes throughout the geographical areas where the firm is located. Mr. Gradwohl would like to thank Ms. Corbett for all of her help in writing, editing and organizing this article.

I. OVERVIEW

In early December 2008, Bernard L. Madoff ("Madoff"), legendary New York financier, proclaimed first to employees and then to the media that he had engaged for years in a "Ponzi scheme" which involved $50 billion of investors' money.[1] With the announcement of that Ponzi scheme, investors abruptly came to the realization that Madoff's payments of inflated returns on investments were no longer possible.[2] His account statements were false.[3] He never earned enough in his investments to justify such a return.[4] Furthermore, the return of their original investments was seriously in doubt.[5] The Securities Exchange Commission ("SEC") quickly stepped in, and, following a script repeatedly used by the SEC in recent years under similar situations, started an equity receivership action in the United States District Court for the Southern District of New York.[6] The SEC immediately filed an *ex parte* order to freeze all assets and to stay all other private proceedings against Madoff and his companies.[7] The order allowed the SEC to conduct an investigation into what happened to the funds and allowed it the opportunity to try to collect whatever assets Madoff and his related companies still had so they could be distributed to the fraud victims.[8]

Additionally, beside the receivership action, a parallel action was started by the Securities Investment Protection Corporation ("SIPC") to provide investors with the return of up to $500,000.00 of their investment.[9] Unfortunately, the investments to be returned in the

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[1] BUREAU OF NATIONAL AFFAIRS, SEC, DOJ CHARGE WALL ST. VETERAN OVER MULTI-BILLION DOLLAR PONZI SCHEME, 40 SRLR 2049 (Dec.15, 2008).

[2] *See* SEC v. Madoff, 2008 U.S. Dist. Ct. Pleadings 10791 at *1-*2, *8-*9 (S.D.N.Y. Dec. 11, 2008).

[3] Jack Healy & Diana B. Henriques, *A Madoff Aide, Guilty, Reveals Scheme Details*, N.Y. TIMES, Aug. 12, 2009, at A1.

[4] *See id.*

[5] *See id.*

[6] SEC v. Madoff, No. 08-10791 (S.D.N.Y. Dec. 12, 2008) (order to show cause, temporary restraining order, and order freezing assets and granting other relief).

[7] SEC v. Madoff, 2009 U.S. Dist. LEXIS 30712, *1-*2 (S.D.N.Y. Apr. 10, 2009).

[8] *Madoff*, No. 08-10791 (order to show cause, temporary restraining order, and order freezing assets and granting other relief).

[9] *In re* Bernard L. Madoff Inv. Sec. LLC, 2010 Bankr. LEXIS 495, *5 (Bankr. S.D.N.Y. Mar. 1, 2010). On December 15, 2008, the Court entered an Order based on the Complaint and Application of

Madoff fraud are generally well in excess of that amount, and the SIPC will be entitled to recover from Madoff only what investors paid to him, plus the costs, if Madoff's assets can be found.[10] The SIPC will not provide any return on investment, for example double-digit interest.[11] More importantly, the SIPC will be in competition with the victims of the fraud for the lost investments and to stand first in line to recoup what it pays. In an unusual move for such proceedings, the Madoff equity receivership was transferred from the United States District Court for the Southern District of New York to the Bankruptcy Court for that District for unexplained reasons.[12] As a result, bankruptcy practice and procedure will govern the Madoff equity receivership.[13]

The equity receivership action for Madoff will presumably follow the same course and use the same procedures used by the SEC in similar prior actions. Equity receiverships are designed to obtain assets that have been left in the possession, custody or control of the perpetrator of the fraud.[14] They are not intended to pursue claims against third parties.[15] Victims of the Madoff Ponzi scheme, and other similar fraudulent conduct, must realize that equity receiverships will not provide them with a full recovery of their investment. In order to maximize their recovery, other proceedings must be initiated.

II. WHO WAS CHARLES PONZI AND WHAT WAS HIS SCHEME

A. Background Information

In order to understand the benefits and drawbacks of an equity receivership, it is necessary to understand the nature and intricacies of a Ponzi scheme. The term "Ponzi scheme" has achieved an established position of instant recognition in American jurisprudence and a certain

the SIPC appointing Irving H. Picard, Esquire, as Trustee to liquidate Madoff's business. *Id.* at *8-*9.

[10] *See generally id.* at *53-*55. There are a limited amount of investments for distribution. *Id.* Any payment of fictitious profits would reduce that pool. *Id.*

[11] *Id.*

[12] *See id.* at *1.

[13] *Id.*

[14] *See, e.g.*, SEC v. Black, 163 F.3d 188, 193-94, 197 (3d Cir. 1998); Marion v. Traders & Dealers, Inc., 591 F.3d 137, 147-49 (3d Cir. 2010).

[15] *See, e.g.*, *In re* Bernard L. Madoff Inv. Sec. LLC, 2010 Bankr. LEXIS at *5.

degree of infamy in everyday English parlance.[16] Similar to many such terms added to our legal vocabulary, the term is defined in BLACK'S LAW DICTIONARY to mean "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments."[17] However, it must be noted that a dictionary definition sometimes sterilizes what is otherwise a term of art used to describe a wide variety of fraud, which is just another word for taking money under false pretenses.[18] To breathe life into the term, it is necessary to go back to its origins and then review some examples of fraudulent schemes to identify characteristics of the Ponzi scheme that are unique.

Charles Ponzi came to the United States from Italy in 1903 and settled in Boston, Massachusetts.[19] In 1907, he left Boston and went to Montreal where he spent three years in jail for the crime of forgery.[20] By 1910, he returned to Boston.[21] He was not overly educated, but he was a super salesman.[22] In another era, he would be known as a "flim–flam" man or a "grifter."[23] Undoubtedly, he was a smooth talker with the ability to convince normal people that the most implausible story was possible.[24] He played off the greed of the marketplace.[25] Most of the current persons who practice fraudulent deception have similar characteristics.[26]

Following World War I ("WWI"), Charles Ponzi began to tell a false "tale" about international postal coupons and how investments in such instruments would yield a high rate of return (over fifty percent)

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[16] *See* Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc., 189 F.3d 321, 324 n.1 (3d Cir. 1999) (Circuit Judge Theodore McKee provides a brief description of the history and meaning of "Ponzi scheme").

[17] BLACK'S LAW DICTIONARY 1198 (8th ed. 2004).

[18] *Cf. id.* at 670.

[19] MITCHELL ZUCKOFF, PONZI'S SCHEME, 22, 24 (2005).

[20] *Id.* at 26, 29.

[21] *Id.* at 57, 73.

[22] *Id.* at 22-24.

[23] *See, e.g.*, THE STING (Universal Pictures 1973) (An excellent example of the operation of a "grifter" or "flim flam" man is in the Academy Award winning movie, *The Sting*, where the late Paul Newman called himself a "grifter").

[24] *See* ZUCKOFF, *supra* note 19, at 99-101.

[25] *See id.* at 100-01.

[26] *See supra* text accompanying note 1.

during a short period of time (90 to 120 days) because of the differences in currency exchange rates after WWI.[27] To prove his point, he sold the coupons to investors, and then he would buy them back in 90 to 120 days for 150 percent of what the investor paid.[28] The coupons were Ponzi's own creation — he did not get them from foreign countries; rather, the countries had stopped issuing them before his business was in full operation.[29] In eight months he collected $9,582,000 from investors and issued $14,374,000 of coupons.[30] There was no truth to his tale, and he supported the fraud by paying early investors with funds from new investors.[31] Of course, he kept some of the money and engaged in a lavish lifestyle.[32] In the end, Ponzi's success caused the fraud to be exposed since he could not keep up with attracting new investors so he could generate funds to buy the coupons from the old investors. Eventually, there was a "run" on his office by investors who wanted their money back, but Ponzi was unable to return their investments.[33] He was arrested, convicted and imprisoned for a number of years.[34] Since he was not a citizen, he was deported to Italy in 1934 and died penniless in Rio de Janeiro in 1949.[35]

At the time of Ponzi's scheme, there was no SEC or equity receivership. His investors put Ponzi and his company in bankruptcy and tried various proceedings (for example, preferences actions) to obtain the return of their investments.[36] None of them worked.[37]

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27 *Bald Eagle Area Sch. Dist.*, 189 F.3d at 324 n.1.

28 *Id.*

29 ZUCKOFF, *supra* note 19, at 93-98.

30 Cunningham v. Brown, 265 U.S. 1, 8 (1924); *Bald Eagle Area Sch. Dist.*, 189 F.3d 321. The size of Ponzi's scheme seems small in comparison of Bernard Madoff and other swindlers of the current era.

31 *Id.*

32 *See generally* ZUCKOFF, *supra* note 19 (giving a detailed description of Ponzi's lavish lifestyle).

33 *Cunningham*, 265 U.S. at 8-9 (1924).

34 ZUCKOFF, *supra* note 19, at 283, 289, 304-08.

35 *Id.* at 309, 312-13.

36 *See Cunningham*, 265 U.S. 1; *In re* Ponzi, 15 F.2d 113 (D. Mass. 1926); Cunningham v. Feinsilver, 6 F.2d 92 (D. Mass. 1925); Lowell v. Merchants Nat. Bank, 283 F. 124 (D. Mass. 1922); Lowell v. Brown, 280 F. 193 (D. Mass. 1922); Lowell v. Aston, 272 F. 536 (D. Mass. 1921); *In re* Ponzi, 268 F. 997 (D. Mass. 1920).

37 *See supra* note 36.

B. The Scheme

"Ponzi scheme" has come to describe a number of frauds usually, but not always, involving a pyramid of business entities that are not supported by any underlying business venture.[38] Similar to Charles Ponzi, Bernard Madoff and persons like him promise unreasonable investment returns, but they do not invest the money entrusted to them in the manner that they propose.[39] The person who runs the scheme, often referred to as the perpetrator, uses most of the invested money for personal use.[40] When the pyramid collapses, investors lose the promised profits and most, if not all, of their principal investment.[41] In some cases, there is an underlying business venture, which has failed or suffered substantial losses and the entrepreneur at the center of the failure turns to the pyramid scheme to keep the venture afloat with the faint hope that there will be a recovery.[42]

Ponzi schemes come in a variety of sizes, shapes and businesses. In most Ponzi schemes, the creator of the fraud focuses on a group or a story to attract investors. For example, Madoff used non-profit organizations.[43] Some stories are more complicated than others. Some schemes start with a legitimate premise but swerve into the Ponzi world of fraud when the circumstances do not turn out as anticipated by the perpetrator. For example, in *Vons Co., Inc. v. Federal Insurance Co.*,[44] a company, Premium Sales, engaged in "diverting"[45] and sought

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[38] *See Bald Eagle Area Sch. Dist.*, 189 F.3d at 324, n.1.

[39] *See id.*

[40] *Id.*

[41] *See, e.g.*, Martino v. Edison Worldwide Capital, 189 B.R. 425, 437 n.17 (Bankr. N.D. Ill. 1995); *see also* Jobin v. Matthews, 184 B.R. 136, 137 n.1 (D. Colo. 1995); *In re* Taubman, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993).

[42] *E.g.*, *In re* Bennett Funding Group, Inc., 213 B.R. 227, 230 (Bankr. N.D.N.Y. 1997) (sale of interest in office equipment leases to investors and the aggregate debts exceeded $1 billion).

[43] Stephanie Storm, *Study Ties Madoff Loss to Charity's Board Size*, N.Y. TIMES, June 25, 2009, at B3. Another group that has been subject to Ponzi schemes is professional athletes. Pablo S. Torre, *How (and Why) Athletes Go Broke*, SPORTS ILLUSTRATED, Mar. 23, 2009, at 90. In December 2009, the SEC sued Triton Financial and its CEO, Kurt Barton, for defrauding a group of professional athletes. SEC v. Triton Fin., LLC, No. 09-924 (W.D. Tex. Dec. 22, 2009). The SEC based its claims in part on a Sports Illustrated article, *How (and Why) Athletes Go Broke*. *Id.* Triton's scam was a promise to buy an insurance company with the money raised, but the insurance company was never purchased. *Id.*

[44] 57 F. Supp. 2d 933 (C.D. Cal. 1998).

[45] "Diverting" is the legitimate practice of buying merchandise in a part of the country where the

investors for specific transactions that operated in partnerships known as "funding entities." Premium Sales offered investors a return on their investment of one percent per week.[46] The promise was too good to be true because a good part of the diverter's business was fraudulent.[47] Reminiscent of Ponzi's scheme, Premium Sales used money from new investors to pay off the old investors.[48] Other examples of Ponzi schemes and the losses caused by the fraud include: perpetrators who induced investors to provide funds to purchase merchandise to be resold to retailers, but no such purchases were ever made resulted in a loss of \$3.65 billion;[49] an attorney who induced investors to loan money to non-existent borrowers to pursue sexual harassment and whistle-blowing lawsuits using multiple bank accounts and phony bank documents resulted in a loss of \$1.2 billion;[50] perpetrators who formed a corporation, induced 900 clients to invest and moved the money to accounts in thirteen foreign counties;[51] perpetrators who misappropriated money to be used to construct health care facilities for personal use using an unregistered securities offerings that resulted in a loss of \$3.75 million;[52] perpetrators who used a number of corporations to extract money from investors by promising the money would be invested at a high rate of return resulted in a loss of \$35 million;[53] use of unregistered securities by perpetrators to raise money for promised but unbuilt real estate projects resulted in a loss of \$1.38 million;[54] perpetrators who invested money that was to be used for foreign currency contracts but was spent by perpetrators for lavish lifestyles;[55] "prime bank" scheme supported lavish lifestyle of perpetrators resulted in a loss of \$6.7 million;[56] perpetrators who sold assignment of leases

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retail price is low and selling it to retailers in another part of the country at a price lower than the price paid to a merchandise wholesaler. *Id.* at 935 n.1.

[46] *Id.*

[47] *Id.*

[48] *Id.* at 941.

[49] United States v. Petters, No. 08-364 (D. Minn. filed Oct. 2, 2008).

[50] United States v. Rothstein, No. 09-60331 (S.D. Fla. filed Dec. 1, 2009).

[51] United States v. Welsh, No. 04-00148 (E.D. Va. filed Oct. 11, 2006).

[52] SEC v. Rainmaker Managed Living LLC, No. 05-06121 (C.D. Cal. filed Aug. 22, 2005).

[53] Conder v. Union Planters Bank, N.A., 384 F.3d 397, 398 (7th Cir. 2004).

[54] SEC v. First United Fin. Group, LLC, No. 04-1601 (D.D.C. filed Sept. 15, 2004).

[55] Commodity Futures Trading Comm'n v. DaSilva, No. 04-07609 (S.D.N.Y. filed Sept. 29, 2004).

[56] SEC v. RC Inv. Corp., No. 04-7400 (C.D. Cal. filed Sept. 9, 2004).

that did not exist or had already been sold;[57] Ponzi scheme to buy receivables of latex glove manufacturers which would yield returns of fifteen percent to twenty percent every 90 days resulted in a loss of $164 million;[58] and alleged investment in a "secret" European securities market which was risk-free and would generate lucrative returns resulted in a loss of $75.8 million.[59]

Charles Ponzi's scheme caused a huge amount of notoriety in the early 1920's, perhaps because many of the defrauded investors were members of Boston's Police Department.[60] However, Ponzi's scheme was not the first fraud of its type in the United States, nor was it the most notorious. Those superlatives may be more applicable to the fraud perpetuated on former President Ulysses S. Grant and his family who invested all of their assets with Grant's partner and "friend," Ferdinand Ward who used Grant's prestige as "collateral" to attract investors.[61] Ward took all of the investments and then spent the money for his own personal use.[62] When the fraud ended, millions of invested dollars were depleted to nothing, and Grant was penniless.[63] None of the investment money was recovered, and Grant was blamed for the fraud, although it was later determined that he was an innocent dupe.[64]

While the Ponzi scheme engineered by Bernard L. Madoff Investment Securities LLC may end up being the largest fraud in terms of dollars lost, it is not unique. As was the case with the Charles Ponzi scheme and the earlier scheme manufactured by President Grant's friend, Madoff bilked innocent victims of substantial sums of money in return for the promise of unrealistic returns on investments well beyond what was available in the market.[65] Unreasonable belief in excessive

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[57] Achtman v. Kirby, McInerney & Squire, 404 F. Supp. 2d 540 (S.D.N.Y. 2006); Achtman v. Kirby, McInerney & Squire, 336 F. Supp. 2d 336, 338 (S.D.N.Y. 2004).

[58] SEC v. J.T. Wallenbrock & Assoc., 313 F.3d 532, 535-36 (9th Cir. 2002).

[59] SEC v. George, 426 F.3d 786, 788 (6th Cir. 2005).

[60] ZUCKOFF, *supra* note 19, at 15. It is estimated that nearly three-quarters of the Boston Police Department had invested with Charles Ponzi. *Id.*

[61] JEAN EDWARD SMITH, GRANT, 619 (2001).

[62] *Id.* at 620-21.

[63] *Id.* at 621.

[64] *See generally id.* To regain some financial stability, Grant wrote his memoirs while he was dying of cancer. *Id.* at 622-24. Those memoirs were published by Mark Twain, and the proceeds were given to Grant's widow and family. *Id.* at 622-24, 27.

[65] *See* Healy & Henriques, *supra* note 3.

riches seems to be the trademark of Madoff's classic Ponzi scheme.[66] With Madoff, the engine of fraud churned on until the collapse of the securities markets caused new investors to stop feeding the scheme and made it impossible for Madoff to continue.[67] Like a game of musical chairs, when the music stopped, there was no place for the Madoff investors to sit. With no way out, Madoff gave up trying to cover-up the fraud and confessed to perpetrating a massive Ponzi scheme.[68]

The SEC stepped into the void created by Madoff's confession in order to find out what happened to the lost investments, as well as to give as much money as could be easily found back to investors.[69] It is unlikely, however, that the Madoff receivership proceedings will find enough money to repay 100 percent of the invested funds to the victims.[70] Nevertheless, there are other remedies available to the victims, and not to the receiver, which will result in a much larger recovery.

III. ANATOMY OF AN EQUITY RECEIVERSHIP

It is important to understand what happened in past receiverships in order to demonstrate how an equity receivership works in practice, as well as its strengths and weaknesses in recovering any lost investments. An example of an equity receivership that achieved moderate success in recouping some, but not all, of the investments of its victims is *SEC v. Black*.[71] The *Black* receivership itself ended after the investigation was completed and the money that could be found easily was returned, but without the victims getting all of their money back.[72] However, with the assistance of independent counsel who filed federal and state class actions, bankruptcy claims, and other related cases, the victims

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66 *Id.*

67 *See* Julie Creswell & Landon Thomas, Jr., *The Talented Mr. Madoff*, N.Y. TIMES, Jan. 25, 2009 at BU1; Catherine Rampell, *A Scheme With No Off Button*, N.Y. TIMES, Dec. 21, 2008, at WK5.

68 BUREAU OF NATIONAL AFFAIRS, *supra* note 1 (stating that Madoff confessed to "a giant Ponzi scheme").

69 *Id.*

70 *Id.* (reporting that Madoff said he had "absolutely nothing").

71 163 F.3d 188.

72 *See e.g.*, *id.* The victims lost $70 million from Black's Ponzi scheme, and despite recoveries by the receiver and from other sources, by 2002 the unrecovered losses totaled $16.7 million. Daniel Boone Area Sch. Dist. v. Lehman Bros., Inc., 187 F. Supp. 2d 400, 402 n.4 (W.D. Pa. 2002).

eventually obtained the return of all of their investments from third parties, for example banks, lawyers, accountants investment banks and others, who contributed to Black's Ponzi scheme in very significant ways.[73] As the *Black* case demonstrates, the equity receivership device is a good starting point for determining what happened, and collecting the investments which are left, but it will not maximize the recovery of the investments due to certain inherent limits in the equity receivership procedure and the rights of the receiver to pursue claims.

Friday, September 26, 1997, was a typical early fall day in the small town of Tyrone, Pennsylvania.[74] Located a few miles away from Johnstown and Altoona in scenic Blair County, the citizens went about their business preparing for the main source of entertainment and pride, the Friday night football game at Tyrone Area High School. Similar to many towns in the mountains of western Pennsylvania, the economy of Tyrone was depressed due to reduced demand for steel and coal which were once the mainstays of life there. Main Street had closed, with a few exceptions, and most citizens commuted many miles to their place of work, but returned every night to the peace and quiet of small town America. This rhythm of life had remained unchanged for many years.

One of the few exceptions to the small town description was John Gardner Black ("Black"), the heir to the local candy manufacturing business.[75] Mr. Black, not satisfied with his future in the local community as the local candy scion, had gone into the investment

[73] Bald Eagle Area Sch. Dist. v. Mid-State Bank and Trust Co., Nos. 98-516, 98-2603, 1999 WL 335059 (Pa. Com. Pl. Mar. 31, 1999) (banks); Sch. Dist. of Daniel Boone v. Barbacane, Thornton Co., 759 A.2d 32 (Pa. Super. Ct. 2000) (accountants). In addition, claims against Lehman Brothers, Black's lawyers, and Keystone Financial, Inc. were settled for millions of dollars, which were distributed to the school district's victims. *Daniel Boone Area Sch. Dist.*, 187 F. Supp. 2d 400.

[74] The author represented a school district in the *Black* equity receivership and in related actions. Many facts in the text are based on his personal knowledge. Certain background facts are taken from the following cases: *Bald Eagle Area Sch. Dist.*, 189 F.3d 321, 322-25; *Black*, 163 F.3d at 191-93; *Daniel Boone Area Sch. Dist.*, 187 F. Supp. 2d at 402-03. In addition, information about the Black receivership comes from the Report of the Trustee; First Amendment to Report of Trustee; Trustee's 90 Day Report; Second Report of Trustee; and Supplemental Report to the 30 day and 90 day Reports of the Trustee ("Trustee's Supplemental Report"). These reports were required by the court's initial order in the receivership.

[75] Charles Gasparino & Michael Moss, *Failing Returns: What Happened When A Small Town Trusted Local Financial Wizard—His Risky Investments Bring Fiscal Ruin, Dash Hopes For Improved Schools—Mr. Black Brought to Tears*, WALL ST. J., Dec. 26, 1997, at A1.

advisory business in the late 1980's.[76] Black spent years working in Harrisburg investment banking establishments like Pennsylvania Local Government Investment Trust ("PLGIT"),[77] which provided investment advisory services to small and medium sized school districts and municipalities in Pennsylvania.[78] His specialty was providing investment advisory services to school districts and municipalities in Pennsylvania and other states who raised funds for construction projects through bond issues, which are paid by the taxpayers. The tax-free bonds issued by the school districts and municipalities are regulated by the state and Internal Revenue Service. Black invested the school districts' bond proceeds through his companies, Devon Capital Management, Inc. ("Devon") and Financial Management Sciences, Inc. ("FMS"), in order to maximize the return on the money raised for construction projects.[79] Black also invested funds produced by the sale of tax anticipation notes. Some school districts, for example the one in his hometown, Tyrone Area School District ("TASD"), permitted Black to invest all of their money, whether or not it was generated by tax-free bonds.

In the 1990's, Black was an accomplished salesman to school districts, primarily in western Pennsylvania. Over the ten years of his investment advisory business, Black created a mini-financial empire by catering to the desire of business managers and public boards to beat the usual investment returns on funds which were to be used to build and operate schools, hospitals and other public institutions. The exterior trappings of Black's business were modest, and included a small office in Tyrone, and other smaller offices in Harrisburg and Pittsburgh, with a staff that never exceeded a dozen. The size of the funds handled by

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[76] *Id.*

[77] PLGIT is where school districts and municipalities pool their funds for investments. PLGIT Home Page, https://www.plgit.com/ (last visited Apr. 12, 2010). A similar organization is Pennsylvania School District Liquid Asset Fund ("PSDLAF"). PSDLAF Home Page, http://www.psdlaf.org/ (last visited Apr. 12, 2010). The investments made by PLGIT or PSDLAF are neither insured nor guaranteed by Pennsylvania or the United States. *Id.*

[78] *See* Gasparino & Moss, *supra* note 75.

[79] *Id.* Between the sale of the tax free bond and collection of the proceeds and the use of the funds for construction, there may be a lapse of one to two years. During that time, the funds may be invested in "safe" securities for the benefit of the school districts. However, such investments are subject to severe limitations under the arbitrage regulations of the IRS. *See Bald Eagle Area Sch. Dist.*, 189 F.3d at 324.

Black and his companies was staggering. According to the Trustee's Supplemental Report, during the period of May, 1994 to September, 1997, it is conservatively estimated that Black internally transferred securities valued at about $355 million.[80] As acknowledged by the Trustee's Supplemental Report the conservative estimate may be grossly understated and the aggregate value of securities transferred by Black may have totaled much more. It is a small sum compared to Madoff's $50 billion, but a significant amount of public money. Moreover, the aggregate value of securities held in mid-1994 was more than double the value held in September, 1997. This decline represents losses of $69 million, which were suffered by Black's clients.

Before his fall from grace, some people in and out of Tyrone said that Black was a financial genius.[81] After September 26, 1996, they said he was "crook."[82] Perhaps, he was too smart for his own good. He was not prescient or clairvoyant enough to see or predict that the SEC was coming to shut him down and seize the assets of Devon and FMS. FBI agents, SEC personnel and operatives from other federal agencies, like the IRS and Postal Service, arrived on September 26, at the offices that Devon and FMS shared in Tyrone, prepared to discharge personnel, seize records and close the office.[83] Earlier that day, the SEC had commenced an equity receivership action in the United States District Court for the Western District of Pennsylvania and had obtained *ex parte* orders appointing a trustee, seizing assets, and enjoining Devon, FMS, and Black from further investment advisory operations.[84] The federal agents gave the employees at Devon's office a few hours to wind up their affairs.[85] In a few cases, some employees called

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[80] SEC v. Black, No. 97-02257 (W.D. Pa. Mar. 10 1998) (trustee's supplemental report). The "internal" transfers were among his clients as he moved assets around to cover his substantial losses in the marketplace. *Id.*

[81] *See* Gasparino & Moss, *supra* note 75.

[82] *Id.*

[83] *Id.*

[84] SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (ex-parte order granting temporary injunction and freeze of accounts). The case was originally filed in the Johnstown vicinage and assigned to the Honorable D. Brooks Smith, subsequently Chief Judge of the Third Circuit Court of Appeals. When Judge Smith determined that he had a conflict, since his wife was an officer of Mid-State Bank & Trust Company, Black's custodian bank, the case was transferred to Pittsburgh and assigned to the Honorable Donetta Ambrose, subsequently Chief Judge of the Western District of Pennsylvania. *Id.*

[85] *See* Gasparino & Moss, *supra* note 75.

customers and explained the situation as they understood it. However, there was nothing that the customers could do to protect their interests because sixteen banks and financial institutions were being notified of the asset freeze at the same time that the raids were executed.[86] All accounts affiliated with Devon and FMS were frozen, and even if they were in the name of a school district, the funds were not available for withdrawal.[87] The court appointed as trustee or receiver, Richard "Dick" Thornburgh, former governor of Pennsylvania and Attorney General of the United States.[88] Thornburgh hired his law firm to conduct the investigation and represent him.

The SEC's actions took place after a routine investigation of Devon in early August of 1997, uncovered massive trading losses which had been hidden within Devon's books by materially inflated asset values.[89] Further, the SEC found that Devon and Black were concealing the losses to their clients, were accepting new investment clients without disclosing the losses and were using new funds to fulfill obligations to existing clients, in the nature of a classic Ponzi scheme.[90] As the information was filtered to the media, Black's scheme was described as the "largest municipal fraud in Pennsylvania history."[91]

For over ninety school districts, the equity receivership created on September 26, 1997, did not end until the district court entered an order on January 13, 1999, terminating the services of the Trustee and closing the SEC proceedings.[92] Like the entry of the injunction and asset freeze *ex parte*, which began the equity receivership, the district court entered the memorandum order ending the receivership without any notice to the parties, including the victims, and without the opportunity to request a hearing or to intervene officially. During those eighteen months, the school districts and other municipal entities were subject to the shadowy

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[86] *Id.*

[87] SEC v. Black, No. 97-2655 (W.D. Pa. Sep. 25, 1997) (order appointing trustee).

[88] *Id.*

[89] *Black*, 163 F.3d at 191.

[90] *Id.* at 192-94.

[91] The court used this description at the beginning of its opinion in *Daniel Boone Area Sch. Dist. v. Lehman Bros., Inc.* 187 F. Supp. 2d 400, 401 (W.D. Pa. 2002).

[92] SEC v. Black, No. 97-02257 (W.D. Pa. Jan. 13, 1999) (memorandum order ending the receivership).

and in many ways uncharted world of federal equity receiverships.[93] The operation of the equity receivership is kept secret because the SEC is unsure if any of the alleged victims may be participants in the scheme until the investigation is complete, and as a result, premature disclosure may adversely affect the ability to recover the investments.[94] Consequently, without transparency, there was no free exchange of facts and ideas which should have been used to seek recovery of the lost investments. While some receiverships successfully collect virtually all of the money and return it to the investors, in the Black receivership only fifty percent of the lost investments were recovered.[95] The rest of the money was obtained through independent cases brought by school districts. A similar result is expected in the Madoff equity receivership due to the size of the loss, and the economic downturn in the market.

IV. THE ELEMENTS OF THE EQUITY RECEIVERSHIP

An equity receivership is initiated when a motion or petition is filed by the SEC or a similar governmental agency in the United States District Court.[96] The motion is supported by one or more affidavits detailing the Ponzi scheme, provided by an official of the SEC. [97] The affidavits may include exhibits, which contain proof of the potential losses suffered by investors.[98] While the SEC has the statutory power to

[93] In the *Black* case, besides appearances at a two hearing on the assets freeze and a brief meeting with some, but not all, school districts within one month of the appointment of the receiver, the receiver's communications with the victims of the Ponzi scheme consisted of five reports previously described, which were required under the order establishing the receivership. The equity receiver and his counsel wanted information from the school districts, but they refused to provide any information to the districts.

[94] When the author asked counsel for the receiver (from the receiver's law firm of Kirkpatrick & Lockhart) about certain aspects of the investigative process, he was told that the receiver had to maintain confidentiality to avoid disclosing information to a participant of the scheme with Black. However, the victims of the fraud usually are not participants in a Ponzi scheme. When that anomaly was noted to receiver's counsel, he had no response.

[95] Some victims received all of their investments because they were held in separate accounts owned by the school districts. However, the victims who had their money put in a pooled account with many school districts were not so lucky. *Black*, 163 F.3d at 197-98.

[96] In the *Black* receivership case, the SEC filed a motion for temporary restraining order, including a complaint, affidavits and exhibits. 163 F.3d at 197-98.

[97] *Id.* The petition in the *Black* case included an affidavit by a SEC regional officer who explained how the fraud was uncovered and the details of Black's Ponzi scheme as they were understood before a thorough investigation.

[98] *Id.* The motion in the *Black* case included exhibits identifying four categories of investors. *Id.*

take immediate action against persons subject to its regulatory authority, it appears that a motion like the one in *Black* can include affiliated, non-regulated persons, individuals or corporate entities, who are working with the regulated entity in conducting the Ponzi scheme.[99] In the Black receivership, the order applied to Devon, the regulated entity, Black, and FMS, the affiliated company.[100] In the Madoff receivership the order was directed to Madoff and his various companies, some of which were not regulated.[101] If the filing of a motion or petition sets forth an emergent situation, and most of them do, the court will issue the initial order without service on the respondents and non-parties who are affected by the order, like banks and other financial accounts frozen by the order.[102] In *Black*, the banks who had money deposited by Black and his affiliated companies received a copy of the order before, or at the same time as, Black received the order and his offices were raided by the FBI. This "ambush" approach is necessary to lessen the possibility that the person who created the scheme, or his compatriots, will dissipate or hide funds in advance of the receiver assuming control through the asset freeze.[103] In the *Black* case, there was no warning that a receivership was imminent.[104] The *ex parte* nature of the initial order may be ameliorated by the requirement in the Federal Rules that a hearing must be afforded promptly, usually no more than fourteen days after the entry of the initial order.[105]

The initial order entered by the court in an equity receivership usually includes the following: (1) asset freeze; (2) no intervention by third parties; and (3) blanket stay of all other litigation against the respondents (perpetrators and related entities) by third parties including victims of the Ponzi scheme.[106] In the following sections, the tools

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99 *See, e.g.*, SEC v. J.T. Wallenbrock & Assoc., 313 F.3d 532, (9th Cir. 2002).

100 SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (memorandum order establishing the receivership).

101 *Id.*

102 *See e.g.*, *Black*, 163 F.3d 188. In *Black*, all customer accounts that Black controlled for his customers were immediately frozen without prior notice to Black or his customers. *Id.* Subsequently, the court determined that the asset freeze was overbroad and released accounts which were actually owned and controlled by the school districts. *Id.*

103 *Id.* at 194 n.4.

104 *Id.* at 191.

105 FED. R. CIV. P. 65(b).

106 *See, e.g.*, SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (initial order granting entry of a

provided to the equity receiver to unravel the Ponzi scheme and provide the victims with preliminary relief will be discussed. However, the equity receivership has limitations and does not give victims the ability to be made whole in every situation. Moreover, there is a limitation on the ability of the equity receiver to obtain the principal returned to early investors as part of the Ponzi scheme. While distribution of the funds collected by the equity receiver should be on a pro rata basis, the principal replacement to early investors seems to contradict that equitable principle. Victims need other remedies to regain the investments acquired and dissipated by the perpetrators of the Ponzi scheme, and those remedies are identified in the final section of this article.

V. ASSET FREEZE

Non-bankruptcy receiverships are relatively rare and are based primarily on laws which regulate different types of businesses.[107] No matter the statutory basis, however, one element that every equity receivership has from the outset is an order freezing the assets of the defendant.[108] Most of the time the asset freeze is part of the temporary restraining order or preliminary injunction which includes other items that the equity receiver needs in order to gain control over the alleged illegal activity.[109] This allows the receiver to investigate the situation and determine where the remaining money is, what happened to the money that cannot be found, how the illegal activity was run, and the identity of all of the persons who are responsible for the illegal activity.[110] More importantly, the asset freeze captures the remaining assets invested in the Ponzi scheme so they can be distributed on an equitable basis to the victims of the fraud.[111]

The power to create an equity receivership can come from

temporary restraining order).

[107] Besides equity receiverships under the securities laws, there have been equity receiverships authorized by the Small Business Administration. United States v. Acorn Tech. Fund, L.P., 429 F.3d 438 (3d Cir. 2005).

[108] *See, e.g.*, *Black*, 163 F.3d at 192-93.

[109] *Id.*

[110] *Id.*

[111] *See, e.g.*, *id.*

statutory or non-statutory authority.[112] For example, many equity receiverships are created pursuant to Section 20(b) of the Securities Act of 1933, 15 United States Code Section 77t(b); Sections 12 (d) and (e) of the Exchange Act of 1934, 15 United States Code Section 78u (d) and (e); and Section 209 (d) of the Investment Advisors Act, 15 United States Code Section 80b (d). Under those statutes, the SEC is authorized to seek an equity receivership when violations of the regulatory scheme are detected.[113] Other federal agencies are given similar power under various statutes to seek equity receiverships, like the Commodity Futures Trading Commission, the Small Business Administration, the Federal Trade Commission, and the Federal Deposit Insurance Corporation.[114]

In all equity receiverships, statutory and non-statutory, the authority to freeze assets in the context of a receivership, in whole or in part, is committed to the district court's sound discretion.[115] The freeze of assets is intended to preserve the status quo by preventing the dissipation and diversion of assets, which may be related to wrongful activity.[116] Thus, the freeze is to benefit the victims of the Ponzi scheme. The power to freeze assets is the strongest weapon in the receiver's arsenal of procedural and substantive utilities to gather control of the situation.

However, the scope of the freeze is not without limits and, after the dust of the receiver's takeover settles, the court may unfreeze assets which were mistakenly thought to be controlled by the perpetrator of the Ponzi scheme.[117] In *Black*, the court modified the freeze order to allow a

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[112] Besides the equity receivership authorized by federal statutes, asset freezes can be obtained in state courts through a preliminary injunction to enjoin the dissipation of funds. *See, e.g.*, Citizens Bank of Pa. v. Myers, 872 A. 2d 827 (Pa. Super. 2005) (recognizing that an equitable remedy was proper where claimed relief for unjust enrichment was due to embezzlement and allowing an asset freeze to enjoin the dissipation of funds obtained by defendants' theft.)

[113] *See, e.g.*, *Black*, 163 F.3d 188.

[114] *See, e.g.*, *Acorn Tech. Fund, L.P.*, 429 F.3d 438 (SBA receivership); Commodity Futures Trading Comm'n v. Am. Metal Exch. Corp., 991 F.2d 71 (3d Cir. 1993) (CFTC receivership).

[115] *See, e.g.*, *Am. Metal Exch. Corp.*, 991 F.2d at 79.

[116] *See, e.g.*, SEC v. Infinity Group Co., 212 F.3d 180 (3d Cir. 2000).

[117] Because an asset freeze does not involve any transfer of funds from accounts, but instead requires financial institutions holding the funds to "retain within [their] control and prohibit the withdrawal, removal, transfer or other disposal of any such funds or other assets," the asset freeze may be easily lifted or modified. *Black*, 163 F.3d at 194 n.4.

distribution from certain accounts belonging to some of the victims.[118] The Third Circuit affirmed the district court's action in removing the freeze from certain assets that belonged to victims of Black's Ponzi scheme, never came into the possession of Black or his affiliated corporations, and remained in bank accounts in the name of the school districts.[119] In affirming the removal of the freeze of certain assets, the court reasoned that the "complicity or involvement in wrongdoing . . . necessary to support the unilateral freeze of assets" was not present and that the asset freeze was wrongfully imposed based on a "common enterprise" theory.[120] Without an asset freeze in the beginning of the receivership, there would be no purpose to the appointment of an equity receiver to take over or distribute funds to the victims of the scheme.[121]

VI. NO INTERVENTION BY VICTIMS OF THE PONZI SCHEME IN ACTIONS OF THE EQUITY RECEIVER

Although victims of securities fraud have been permitted, as a matter of right, to intervene in SEC enforcement actions, even where a receiver has been appointed,[122] such intervention, whether permissive or as of right, is denied without prejudice by courts where a Ponzi scheme lies at the heart of the proceeding. For example, in *Black*, virtually every attempt to intervene in the receiver's actions was denied.[123] The

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[118] *Id.* at 193. There were four types of accounts, A, B, C & D. The District Court ruled that the freeze improperly affected accounts A, B & D because they were owned and controlled by the individual school districts. In contrast, account C was a so-called "pooled account" which was owned and controlled by Black. *Id.*

[119] *Id.* at 196-98. The school districts which had funds in account C challenged the lifting of freeze on the grounds that accounts A, B & D were somehow "tainted." However, the Third Circuit noted that the lifting of the freeze was correct because the original Order was overly broad and the District Court had not ruled on the "taint" claims. *Id.*

[120] *Id.* at 197.

[121] In *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 333 (1999), the Supreme Court ruled that an asset freeze in an action for money damages is improper. However, if the case seeks equitable relief, an asset freeze may be justified. *Id. Grupo* does not affect the SEC's rights to an asset freeze, since equitable remedies to preserve the status quo are proper in actions arising under the Securities Act. Dechert v. Independence_Shares Corp., 311 U.S. 282, 289 (1940). The asset freeze is justified because it preserves funds for the equitable remedy of disgorgement. SEC v. Yun, 327 F.3d 1263, 1269 n.10 (11th Cir. 2003); SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978).

[122] *See* SEC v. Flight Transp. Corp., 699 F.2d 943 (8th Cir. 1983).

[123] *See, e.g.*, SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (order denying Daniel Boone Area School District's request to intervene).

primary reason given by the court for such a denial was that there was an "unrebutted presumption" that the receiver and SEC adequately represented the interests of the victims' interest.[124] But clearly, the main purpose of an SEC enforcement proceeding is to enforce the securities laws; secondly, the purpose is to enhance investor confidence by marshaling assets and distributing them equitably. In a complicated situation where there are competing interests for limited funds, like the Madoff scheme or the Black fraud, neither the receiver nor the SEC can or should act for all defrauded parties when the victims will not get a full refund of their investment. The order appointing the equity receiver may be broad, but it does not give him carte blanche to act for the victims.

In opposing intervention, equity receivers have argued that the large number of injured parties, coupled with the complexities of the different relationships, raise complicated factual and legal issues and mandate a "collective" approach.[125] The situation described by the receiver is not dissimilar to a complicated class action. Yet, a class action scenario does not support a stay of other proceedings,[126] or a requirement that all parties join the class and be represented by the class representative.[127] There are due process issues which prevent this type of "collective" approach. Without intervention, a victim has no power to provide input and make alternative suggestions for the distribution of recovered assets.

In opposing intervention, and a stay of separate proceedings, receivers argued that piecemeal litigation will frustrate the purpose of the receivership, grind to a halt the investigation and development of an ultimate distribution plan, and drain the pool of money available to return to victims.[128] Receivers have no case support for such arguments. Yet, they waste a portion of the recovered funds challenging the

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[124] *Id.* Given the limitations on the receiver's ability to pursue claims, as discussed *infra*, it seems extremely unlikely that the receiver represented the victims' interest and could recover the lost investment from third parties.

[125] This was the argument made by the receiver in the *Black* receivership case to any individual school district's request for intervention in the SEC's action. It was also made against Daniel Boone's attempts to bring a separate action against Black and his companies.

[126] *Infra* text section VII.

[127] *See* FED. R. CIV. P. 23.

[128] These arguments were also made by the receiver in *Black*.

victims' attempt to intervene and to stay their separate actions.[129]

The unstated reason for refusing to permit intervention early in the SEC case and the receiver's other cases to collect assets is the receiver's fears that he will be unable to identify all of the perpetrators of the Ponzi scheme and some of them may join in the actions to collect the lost investments. The inability to discern wrongdoers from victims makes the receiver's job difficult, but not impossible. Intervention should be permitted to provide victims with the opportunity to be heard and to help the receiver collect the funds which will ultimately be used to pay the victims the investment produced by the fraud.

VII. BLANKET STAY OF ALL LITIGATION AGAINST THE PONZI SCHEME WRONGDOERS BY THE VICTIMS OF FRAUD

Perhaps the most formidable power in the hands of the equity receiver, besides the asset freeze, is the ability to obtain a "blanket stay" of all litigation against the entities used in the Ponzi scheme or the individual wrongdoers by other defendants in the SEC enforcement proceeding or by non-parties, like victims of the fraud.[130] Usually, the corporate entities or individual wrongdoers who operated the Ponzi scheme do not have sufficient assets to make litigation worthwhile. However, there are situations where a suit against individuals who may have operated the Ponzi scheme may bear fruit. When the blanket stay is part of the original order freezing assets, such actions are not possible without lifting the stay. If a stay is not part of the original order, the receiver will move the court to order a stay of all pending and future litigation except by leave of the court. Such stays may be limited to a time period. In Black's Ponzi scheme, the court granted the receiver's subsequent motion for stay for ninety days during which time the court could assess the appropriateness of continuing or dissolving the stay.[131] In theory, such temporary stays are intended to preserve the status quo.

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[129] Intervention by victims of the Ponzi scheme may assist the receiver in identifying the rights of the victims and may not frustrate the purpose. Moreover, intervention will not drain the pool of available money since the victims will pay for their own representation.

[130] In *Black*, the original order starting the equity receivership did not include a blanket stay.

[131] SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (order granting motion to stay all proceedings for ninety days).

However, even such temporary stays affect the due process rights of the victims because they delay the ability to recover the lost investments.

The seminal case supporting the issuance of a blanket stay in SEC enforcement actions, like an equity receivership, is *SEC v. Wencke* ("*Wencke II*").[132] In the *Wencke* series of three cases, a landlord sought in California state court to regain possession of a leasehold interest held by one of the defendants in a SEC enforcement action.[133] During the pendency of the state case, the SEC had a receiver appointed and an injunction issued against the defendants in the enforcement action. No blanket stay was issued. Later, the landlord obtained a judgment against one of the defendants and attempted to enforce it and to regain possession of the leasehold which was controlled by the receiver. As a matter of ancillary relief, the district court in *Wencke II* granted the blanket stay. The Court of Appeals for the Ninth Circuit affirmed the blanket stay not because it was authorized by the Federal Securities law or Federal Rule of Civil Procedure 65, but rather because it was appropriate ancillary relief under the circumstances to protect the property subject to the receivership and the court found that "an appropriate showing" had been made.[134]

The *Wencke II* court relied in part on the Court of Appeals for the First Circuit's opinion in *SEC v. An-Car Oil Co.*[135] In the *An-Car* case, when the district court established the receivership, it enjoined all creditors from prosecuting their pre-existing actions under the federal securities laws. The appeal arose when the district court terminated the receivership and permitted a voluntary bankruptcy petition. The First

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[132] 622 F.2d 1363 (9th Cir. 1980).

[133] *Id.*

[134] *Id.* at 1369. Arguments have been made by receivers supporting the blanket stay on the basis of 28 U.S.C. § 754 or 28 U.S.C. § 959(a). Neither statute empowers the court to stay all litigation. Section 754 gives the court exclusive control over the property subject to the receivership. However, it does not affect the in personam jurisdiction of a court to hear claims against owners of the subject property. *See* 12 WRIGHT, MILLER AND MARCUS, FEDERAL PRACTICE AND PROCEDURE § 2985 (2d ed. 1987); *see also* Riehle v. Margolies, 279 U.S. 218 (1929). Thus, a judgment may be obtained against the perpetrators of the Ponzi scheme, but it cannot be collected against the property subject to the receivership. Further, the second paragraph of Section 959(a) which in essence provides that receivers may be sued with respect to their actions with respect to the business connected with subject property. Section 959(a) has nothing to do with suing the owners of property (the perpetrators of the Ponzi scheme) rather than the Trustee. In sum, neither statute supports a blanket stay of all litigation against the perpetrators of the fraud.

[135] 604 F.2d 114 (1st Cir. 1979).

Circuit noted that the receiver's work was done and a bankruptcy proceeding was preferred to a liquidation in an equity receivership.[136] The validity of the blanket stay was not an issue before the court in *An-Car*.

The *Wencke II* court also relied on dicta from *SEC v. United Financial Group, Inc.*,[137] where, in a footnote, the Ninth Circuit said that a receivership court had broad equitable powers to prevent interference with the administration of the estate by blanket stay orders.[138] However, in *United Financial*, no blanket stay had been issued, and the district court was required to give full faith and credit to the judgment of the California state court. The Ninth Circuit found that the creditors should be paid from the property subject to the receivership.[139]

In *Wencke II* the court describes the factors necessary for the court to enforce the "public interest" by staying all proceedings brought by non-suit parties.[140] One of the *Wencke II* factors is the "appropriate showing of necessity" arising from a non-party trying to interfere with the court's control over the receivership property.[141] Elements which need to be considered to determine when a blanket stay is a necessity include: (1) marshaling and preserving assets, (2) clarification of financial affairs, (3) independent investigation of claims against former management and other parties,[142] (4) danger of collusive or fraudulent litigation, and (5) expense defending many lawsuits. Given the lapse of time from the appointment of the receiver, the *Wencke II* court sent the case back to the district court for a review of the necessity for a stay and to determine whether an indemnity bond was necessary to protect the

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[136] *Id.* at 117.

[137] 576 F.2d 217 (9th Cir. 1978).

[138] *Id.* at 219 n.1.

[139] *See also* United States v. Crookshanks, 441 F. Supp. 268, 270 (D. Or. 1977) (illustrating that a court can enjoin non-parties whose actions threaten to interfere with prior compliance orders of the court).

[140] The *Wencke II* court also relied on the automatic stay in bankruptcy proceedings. *See* 11 U.S.C. § 362. The court bolstered its conclusion by noting that the stay does not deprive a pre-existing judgment of its effect; it merely postpones the effect. *Wencke II*, 622 F.2d at 1372.

[141] The issuance of a "blanket stay" in *Wencke II* may have been overly broad and unnecessary since the non-party could have been stopped by a single order directed to it.

[142] But the *Wencke II* court noted that "[a]s the receivership progresses . . . it may become less plausible for the receiver to contend that he needs more time to explore the affairs of the entities. *Wencke II*, 622 F.2d at 1374.

creditor's interest.[143] The *Wencke II* standard has been used by a number of district courts to analyze whether a blanket stay should be lifted.[144]

Twenty-five years after the *Wencke II* decision, the Court of Appeals for the Third Circuit addressed the standard to be used in determining when to lift a receivership stay of litigation for the first time in *United States v. Acorn Technology Fund L.P.*[145] In *Acorn*, the Small Business Administration ("SBA") became the receiver for Acorn as authorized by United States Code Section 687(c). The district court issued an order staying all civil litigation involving Acorn, the SBA, or any of Acorn's past or present officers, directors, managers, agents or general or limited partners.[146] The SBA as receiver sued the Barracks, husband and wife, to force them to pay the outstanding balance on two subscription agreements. The Barracks asked the district court to lift the stay so they could counterclaim and the district court refused.

At the outset, the Third Circuit noted that non-bankruptcy receiverships are rare, and it is not surprising that the exact issue presented in *Acorn* had not been presented previously.[147] While the purposes of receiverships are varied, the receiver's job is clear—"marshal and untangle a company's assets without being forced into court by every investor or claimant."[148] Unlike the *Wencke II* court, the Third Circuit recognized that there had to be a safety valve, which allows potential litigants to seek the court's permission to sue so that a day in court was not denied during a lengthy stay. The Third Circuit saw a substantial difference between claims made early in a

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143 Many courts have cited *Wencke II* for various propositions not involving the issuance of a blanket stay. For example, in *SEC v. Vision Comm., Inc.*, 74 F.3d 287, 291 (D.C. Cir. 1996), the court did not approve a blanket stay, but merely noted, citing *Wencke II*, that a district court has broad power to issue ancillary relief when it has control over the property placed in the receivership.

144 *See, e.g.*, FTC v. 3R Bancorp, 2005 WL 497784 (N.D. Ill. 2005) (relying solely on the first and second *Wencke II* factors after determining that the claim might have merit); United States v. First Wall St. SBIC, L.P., 1998 U.S. Dist. LEXIS 9487 (S.D.N.Y. 1998) (receiver did not object to partial lifting of the stay); United States v. ESIC Capitol, Inc., 685 F. Supp. 483 (D. Md. 1988) (receivership is two years old and stay lifted to permit foreclosure action against property on which receivership also had judgment lien). Additional district court cases are cited by the Third Circuit in *Acorn*. 429 F.3d at 444 (3d Cir. 2005).

145 *Acorn*, 429 F.3d 438.

146 *Id.* at 442.

147 In a footnote, the court noted that the issue was not raised in *Black*, because that case dealt with an asset freeze and not a blanket stay of legal proceedings. 163 F.3d at 443 n.2.

148 *Id.* at 443.

receivership, which may disrupt the receiver's duties and claims, and those claims made far into the receivership where there would be less reason to protect the receiver from suit.[149]

In judging whether to lift the stay, the Third Circuit ruled that the district court does not need to judge the merits of the claim, but rather need only to determine whether a party has a colorable claim to assert which justifies lifting the stay.[150] If a claim has merit, then the district court should address the other *Wencke II* factors.[151] After considering *Wencke II* and other appropriate case law, the Third Circuit concluded that the *Wencke II* test should be applied in determining whether to lift the receivership blanket stay of all litigation.[152] Moreover, a district court's application of the *Wencke II* test would be reviewed on appeal under the abuse of discretion standard.[153]

In *Acorn*, the court applied the test and found that the Barracks' claim was unlikely to succeed and there was less reason to make the receiver defend the action rather than defer the claim's resolution.[154] The claim in *Acorn* is somewhat different than claims by victims of Ponzi schemes against the perpetrators. Such claims are not against the receiver, and the receiver will not have to defend the claims. While there should be some power to stay actions which disrupt the receivership proceedings, such power should not be unfettered. Victims of the Ponzi scheme should be permitted to pursue claims and recover their investments, especially in situations where the receiver cannot pursue certain claims due to the lack of standing or *in pari delicto* defense.

VIII. LIMITATIONS ON THE POWERS OF THE EQUITY RECEIVER

While it may appear from the previous discussion that the powers of the equity receiver are ubiquitous, perhaps even omnipotent, there are

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149 *Id.* at 443-44. The Ninth Circuit reversed a refusal to lift the blanket stay seven years into the receivership when the receiver was about to distribute assets and disturb the status quo of the estate. *Wencke II*, 742 F.2d at 1232.

150 *Acorn*, 429 F.3d at 444; *see Wencke II*, 742 F.2d at 1232.

151 *Acorn*, 429 F.3d at 444.

152 *Id.*

153 *Id.* at 442.

154 *Id.* at 445.

serious limits on what equity receivers can do to gather the money lost in Ponzi schemes so it can be returned to the victims of the "pernicious fraud."[155] First, and foremost, the equity receiver, like a bankruptcy trustee, stands in the shoes of the entity used to perform the Ponzi scheme.[156] Although the persons who control that scheme, whether it is a corporation, partnership, limited liability corporation, limited liability partnership or some other business organization, are the guilty parties, the equity receiver acts within the strict confines of the rights and claims available to that entity. Thus, the general rule for actions brought by the equity receiver against the participants in the Ponzi scheme who are not victims[157] is that "an equity receiver may sue only to redress injuries to the entity in receivership."[158] The equity receiver consequently can only bring actions to address injuries to the entity and not to the investor/victims of the scheme.[159]

Second, although an equity receiver can bring an action against the perpetrators of the Ponzi scheme, and the receiver often does, the perpetrators lack the financial wherewithal to repay the victims of the scheme. Somehow, the money dissipates for a variety of reasons, like bad investments, payments to the old investors with the new investments, personal expenditures for frivolous purposes,[160] and so on.

Third, an equity receiver, like a bankruptcy trustee, lacks authority to bring a claim directly on behalf of the debtor's creditors, the victims of the Ponzi scheme.[161] In other words, the powers of the equity receiver

[155] As Judge Diamond noted in *SEC v. Forte*, Ponzi schemes are "pernicious because they masquerade as legitimate investments." 2010 U.S. Dist. LEXIS 24705 at *1 (E.D. Pa. Mar. 17, 2010).

[156] The purpose of an equity receiver is akin to that of the Bankruptcy Trustee; bring money into the estate to repay creditors. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 348-49 (3d Cir. 2001).

[157] It is difficult at times to divide victims from participants in the Ponzi scheme.

[158] Scholes v. Lehmann, 56 F.3d 750, 753 (7th Cir. 1995).

[159] *See* Wuliger v. Mfrs. Life Insur. Co., 567 F.3d 787, 795 (6th Cir. 2009) ("[T]he purpose of a receiver [is] to marshal the ... entities' assets ... so that the assets may be distributed to the injured parties in a manner the Court deems equitable."); *see also* SEC v. Hardy, 803 F.2d 1034, 1038 (9th Cir. 1986) ("[A] primary purpose of equity receiverships is to promote orderly and efficient administration of the estate ... for the benefit of creditors.").

[160] In one case, the perpetrator of the scheme bought one of the environmental suits used by astronauts on the moon and used a great deal of money to support his girlfriend (a former *Playboy* playmate) in producing a movie. The movie was never made. *See* United States v. Yao, 2008 U.S. Dist. LEXIS 13058 (D. Del. Feb. 21, 2008).

[161] *See* Caplin v. Marine Midland Trust Co., 406 U.S. 416, 421-34 (1972).

do not extend to taking the causes of action which belong to the victims of the Ponzi scheme and pursuing them, even though any recovery by the equity receiver would theoretically benefit the estate of the entity and ultimately all of the victims. However, it is conceivable, and even likely, that not all victims are entitled to a portion of the recovery under different theories of liability against different defendants who did not run the Ponzi scheme, but merely facilitated its operation.[162] Hence, the equity receiver's lack of authority to sue on the behalf of the victims is based on sound equitable legal grounds.

Fourth, another equitable concept which bars an equity receiver from pursuing certain claims is the defense of *in pari delicto*. The idea behind that defense is that a "plaintiff wrongdoer cannot recover from a defendant wrongdoer."[163] While the equity receiver is technically not a wrongdoer, he stands in the shoes of the entity through which the wrongdoer performed. Thus, the defense of *in pari delicto* is applicable to the equity receiver and can be asserted by an entity who assisted in the perpetration of the Ponzi scheme. For example, in the John Gardner Black municipal fraud in Pennsylvania, the equity receiver was barred by *in pari delicto* from pursuing claims against Lehman Brothers who sold derivative instruments to Black while knowing Black improperly used money from Pennsylvania school districts. As noted by the Third Circuit in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,[164] the *in pari delicto* defense is separate from the standing of the equity receiver to pursue claims against the wrongdoers in the Ponzi scheme.

Fifth, an equity receiver may only pursue claims for which he has standing.[165] This standing is not the same as the concept of constitutional standing. Rather, it is a standing issue which requires (1) a cognizable injury suffered by the plaintiff; (2) traceable to the challenged actions of the defendant; and (3) the injury is redressable by

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[162] *See e.g.*, Daniel Boone Area Sch. Dist. v. Lehman Bros., Inc., 187 F. Supp. 2d 400 (W.D. Pa. 2002).

[163] *In re* Citx Corp., 448 F.3d 672, 681 n.12 (3d Cir. 2006).

[164] 267 F.3d at 348-49.

[165] Standing and the authority to pursue the claim would appear to be interchangeable concepts. However, since courts have discussed at times standing as distinguished from the authority to sue issue, they are treated separately in this discussion.

account.[166] This standing in no way depends on the merits of the plaintiff's contention that particular conduct is illegal.[167] Standing has been a formidable barrier to the equity receiver's pursuit of claims against non-perpetrators of the Ponzi scheme. For example, in *Izzo v. Mid-State Bank*[168] the case was dismissed by the court because the equity receiver in the Black receivership case lacked standing to sue the bank that provided Black with the ability to pursue the scheme by operating trust accounts for the funds supplied by school districts.

However, in *Marion v. Traders and Dealers, Inc.*,[169] the court held that the claim of the equity receiver, David H. Marion, former chancellor of the Philadelphia Bar Association and experienced litigation lawyer, that the defendants, which included a bank, helped the perpetrator of the Ponzi scheme to enter into more investment contracts was enough to step "over the relatively low standing threshold."[170] The Third Circuit held that an equity "receiver no doubt has standing to bring suit on behalf of the debtor corporation against third parties who allegedly helped that corporation's management harm the corporation."[171] The separate corporate form used by the perpetrator of the Ponzi scheme made it possible to "step over" the standing hurdle.[172]

Crossing the standing barriers in *Marion*, though, did not give the equity receiver success.[173] The Third Circuit found that there was a lack

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[166] Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-61 (1992).

[167] *See* Warth v. Seldin, 422 U.S. 490, 500 (1975).

[168] No. 98-755 (W.D. Pa. Mar. 24, 1999) (opinion and order of dismissal).

[169] 591 F.3d 137.

[170] *Id.* at 148.

[171] *Id.*

[172] *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 346-54 (3d Cir. 2001). (holding that that a creditor's committee, acting on behalf of the corporation, had standing to bring suit against third party professionals who conspired with the corporation's management to prolong the Ponzi scheme by offering professional opinions); see also, *Thabault v. Chait*, 541 F.3d 512 (3d Cir. 2008), where the court, without discussing standing, held that a corporation suffered separate from the injury to the creditors when negligent auditing allowed the corporation to write insurance policies that lacked reserves.

[173] At the time of trial, Marion said that he had already recovered more than ninety-one percent of the victims' funds. This is a great result by an equity receiver. Most Ponzi scheme receivers fail to recover fifty percent of the money invested in the scheme by the victims. It is doubtful that Madoff's equity receiver will be able to recover fifty percent of the investment losses. In contrast, in the Black Ponzi scheme, through the joint efforts of the receiver and counsel for the school districts, virtually all of the lost investments were recovered.

of proximate causation between actions of the defendant and the harm that the corporate entity suffered.[174] "Between the initial act (the injecting of money into the business) and the end result (the expansion of the company's debt relative to where it was prior to the cash infusion) stand the intervening acts of the company's management (i.e., what it chose to do with the money)."[175] There cannot be liability to a corporation for increasing short term liquidity.[176] Furthermore, the losses the corporation suffered were due to subsequent actions of the perpetrator of the Ponzi scheme and not the bank that provided the additional funds. Thus, another limitation on the equity receiver's remedies is the proximate cause requirement.[177]

The court in *Marion,* acknowledged that the proximate cause issue may not be insurmountable if a similar claim were brought by the investors who were victims of the Ponzi scheme.[178] The investors have claims which may not be pursued by the equity receiver and which may be pursued against third parties with sources of funds which can provide the return of their lost investments.

Before discussing the remedies available to victims of the Ponzi scheme and not the equity receiver, a few comments are necessary about the distribution of funds recovered by the equity receiver.

IX. RETURN OF PRINCIPAL AND PRO RATA DISTRIBUTION

Ponzi schemes by their very nature treat investors differently depending on the time that the victims made their investments. Early investors sometimes get their principal investment back plus the promised interest or profit. Later investors provide the funds for the return of the principal, plus interest and profit, and when the "music" of

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[174] *Marion*, 591 F.3d at 150-51.

[175] *Id.* at 150.

[176] *Id.*

[177] In *Daniel Boone Area School District v. Lehman Brothers, Inc.*, Lehman argued that the school districts lacked standing under Article III because they had no "injury-in-fact." 187 F. Supp. 2d at 403-44. The court rejected that argument but noted the real argument was that the losses were not causally connected to the conduct of Lehman. *Id.* The court warned, though, that Lehman was on "shaky ground" in arguing about the traceability requirement. *Id.* The court noted that there was a "sea of uncertainty" surrounding the issue. *Id.*

[178] *Marion*, 591 F.3d at 150-51.

the scheme stops,[179] there is no money to return the investments to all victims. Courts have tried to determine the most equitable distribution of the remaining funds without any satisfying success.

In the Madoff Ponzi scheme, the receiver is pursuing so-called "clawback" cases against earlier investors who got their money back, plus profits, at the expense of the later investors. Such "clawback" cases are based in part on the Uniform Fraudulent Transfer Act.[180] But these cases have produced insufficient funds to pay the later investors the principal that they invested, much less the profits or interest that they were promised by the perpetrators of the Ponzi scheme. Furthermore, federal agencies like the SEC and the Commodity Futures Trading Commission ("CFTC"), have not requested the return of the principal which early investors were permitted to keep, while they disgorged the profits or interest. In the wake of the "extraordinarily unfair" method of distributing the assets of the Ponzi scheme, some courts have suggested that the assets should be returned in a pro rata fashion.[181] Nevertheless, the pro rata distribution has been routinely rejected because a receiver has no claim to an early investor's principal because he is an "innocent investor."[182]

Perhaps, the most remarkable aspect of the distribution issue is the position being taken by the SEC and related agencies like the CFTC. For example, in *SEC v. Forte*,[183] forty-one early investors provided the perpetrator of the Ponzi scheme with $32 million and recouped $41 million in principal and profits paid by eighty-three investors who recouped nothing. The receiver negotiated a settlement of claims against two early investors where they would repay only the profits that they received and not the principal that was returned. The receiver's counsel had wanted to seek the return of the principal and sought the advice of the federal agencies. The SEC and CFTC informed the

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[179] At times, Ponzi schemes are described as involving a complicated game of "musical chairs."

[180] The Act is codified in Pennsylvania at 12 PA. CONS. STAT. ANN. §§ 5101-5110 (West 2009).

[181] *See, e.g.*, SEC v. George, 426 F.3d 786, 798-99 (6th Cir. 2005) (remarking that early investors should return profits and principal when hundreds of later investors who were victimized will receive only forty-two percent of the money they invested, not the one hundred percent they claim to be entitled); *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002) (remarking that early investors returns are generated by the influx of fresh capital from unwitting newcomers).

[182] *See e.g.*, Donell v. Kowell, 533 F.3d 762, 770 (9th Cir. 2008); *Scholes*, 56 F.3d at 757-58.

[183] SEC v. Forte, 2009 WL 4809804 (E.D. Pa. Dec. 15, 2009).

receiver's counsel that if the return of the principal were sought, the agencies would litigate the issue in the district court and before the Third Circuit.[184] Neither the SEC nor the CFTC explained their position opposing the recovery of principal to the court. The SEC had taken the same position in another case involving the Stanford Ponzi scheme in Texas.[185] Apparently, the SEC and CFTC have adopted a national policy that there can be no recovery of returned principal from early Ponzi scheme investors even when the investors should have seen red flags alerting them to the true nature of their investments. The receiver's counsel in *Forte* speculated that the SEC and CFTC apparently believe that "claims for principal should be asserted only against [investors] as to whom there is individualized evidence that they were on inquiry notice with respect to the operations of the [Ponzi scheme], in addition to the red flags known to all [investors]."[186] The court in *Forte* described this requirement as sort of mens rea which limited recovery of principal from investors who share the criminal intent of the perpetrator of the Ponzi scheme.[187]

If the return of the principal is pursued from all investors, the receiver would significantly increase the funds to be distributed pro rata to all victims of the Ponzi scheme.[188] In *Forte*, while the court thought that it was more equitable for the receiver to pursue the collection of principal and profits, and to distribute the amount collected on a pro rata basis, the court approved the settlements to avoid the threatened litigation by SEC and CFTC.[189] However, the court emphasized the

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[184] *Id.* at *3.

[185] *See* Janvey v. Alguire, 588 F.3d 831, 834 (5th Cir. 2009). In *Janvey*, "the SEC argued to the Fifth Circuit that the receiver's claims to recover principal lacked statutory and case law support, and it would be inequitable to require the innocent investors to repay the principal." *Forte*, 2009 WL 4809804 at *5. The SEC also contended that any claims for principal under the fraudulent transfer law would fail because the investors received the returned principal in "good faith." *Id.*

[186] *Forte*, 2009 WL 4809804 at *5. *See In re* Burry, 309 B.R. 130, 135 (Bankr. E.D. Pa. 2004) (stating that an investor who had sufficient knowledge to place an inquiry notice of the voidability of the transfer does not meet the "good faith" test).

[187] *Forte*, 2009 WL 4809804 at *5.

[188] *See* Cunningham v. Brown, 265 U.S. 1, 13 (1924) (ordering a pro rata distribution of all recovered funds to all victims of the original Ponzi scheme perpetrated by Charles Ponzi); SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 89 (2d Cir. 2002) (courts favor pro rata distribution of assets where the funds of the victims are similarly situated with respect to their relationship to the perpetrators of the fraud).

[189] *Forte*, 2009 WL 4809804 at *6.

same result may not apply if the earlier investor received a greater return of principal than the two investors who were parties to the settlements.[190]

In an equity receivership, district courts have wide discretion to fashion distribution plans to recover investors' lost assets.[191] In a Ponzi scheme, all victims are invested in a common enterprise. Equity takes a broad view of commingling and requires courts to focus on the forest rather than the trees. Public policy supports the equality of distribution of the remaining assets in a Ponzi scheme. Even if victims may be able to establish priority claims to assets, the court may mandate a pro rata distribution based on the equities. For example, in *United States v. Durham*,[192] all victims stood equal in terms of the Ponzi scheme and there was no abuse of discretion where the trial court disregarded certain priorities and ordered a pro rata distribution. In most Ponzi schemes, the victims' rights and claims are inextricably intertwined. In a Ponzi scheme, the perpetrators of the fraud juggle funds in order to entice new investors, deliver promised returns, and so on. The Ponzi scheme is a case of a virus infecting everyone associated. Under those circumstances the only equitable remedy is to distribute assets in a pro rata manner.[193]

X. AVAILABLE REMEDIES TO THE VICTIMS OF THE PONZI SCHEME OUTSIDE THE EQUITY RECEIVERSHIP PROCEEDINGS

Since the equity receivership is not empowered to bring actions on

[190] *Id.* No matter when the investment in the Ponzi scheme is made, the principal payment immediately disappears into the commingled funds when it is made. For example, in the Black Ponzi scheme, one school district made its investment two (2) weeks before the equity receiver was appointed but after the SEC had discovered the existence of the Ponzi scheme. Nevertheless, the District Court refused to return the principal payment, even though it was inequitable to keep it. SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (order denying relief to Jennette Area School District). The position of the receiver was that once the money came into the possession of the Ponzi scheme, it was lost forever to the victim. *Id.*

[191] SEC v. Infinity Group Co., 226 Fed. Appx. 217, 218 (3d Cir. 2007); SEC v. Fischbach, 133 F.3d 170, 175 (2d Cir. 1997).

[192] 86 F.3d 70 (5th Cir. 1996).

[193] It is questionable how successful the clawback cases in the Madoff Ponzi scheme are going to be. The Madoff case may be the exception to the SEC and CFTC position that principal should not be recoverable.

behalf of the victims of the Ponzi scheme against third parties,[194] the burden of collecting from those third parties falls squarely on the shoulders of the victims themselves. In most Ponzi schemes the uninvested money has been dissipated by greed, avarice, unwise investments in security markets and other expenses so that there is little or even no money left to return to the victims. As a result, the equity receivership proceeding lacks the litigation tools to find where the money went and how to bring it back to the victims. As the preceding section to this Article relating to pro rata distribution demonstrates, there is a dispute among the regulatory agencies and the courts whether all of the money must be returned to a common "pot" for distribution to the victims.

The following identifies a number of third parties who may be pursued by victims of the Ponzi scheme outside the context of the equity receivership.

A. The Problems with Bankruptcy

Claims by the bankruptcy trustee appointed to represent the corporate entities used by the perpetrators of the Ponzi scheme are subject to the same deficiencies faced by the equity receiver. The equitable defense of *in pari delicto* applies because a bankruptcy trustee stands in the shoes of the bankrupt entity and is subject to the same defenses.[195] Similarly, a bankruptcy trustee lacks standing to pursue claims brought by creditors of the bankrupt entity. Nevertheless, there are claims available to the bankruptcy trustee which are better pursued in that jurisdiction, rather than the jurisdiction where the equity receivership came into being. However, in most equity receiverships the court's first order prohibits the entities which are used by the perpetrator of the fraud from filing bankruptcy. Accordingly, the equity receivership court stops any bankruptcy proceeding until the equity receivership has been concluded or is well on its way to the

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[194] While the equity receiver is charged with collecting the investments for distribution to the victims, he/she lacks standing and may be burdened by the *in pari delicto* defense from pursuing claims against third parties who facilitated the scheme.

[195] Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001) (applying *in pari delicto* defense to bankruptcy trustee without regard to trustee's status as an innocent successor).

conclusion.[196]

In *Black*, the original order stopped the victims of the Ponzi scheme from filing involuntary bankruptcy petitions directed to Devon and FMS until the court amended its opening order over the opposition of the receiver to permit an involuntary Chapter 7 bankruptcy against the two corporate entities used by Black to run his fraud. Despite the district court's decision in *Black* to permit an involuntary bankruptcy petition, the equity receiver opposed that petition.[197] Only after an evidentiary hearing and the bankruptcy court's granting of the orders for relief did the receiver decide to turn over the remaining assets to the bankruptcy court.[198]

In the *Black* cases, the move from the equity receivership to the bankruptcy court provided a forum whereby the victims could participate with the trustee in the collection of the funds and distribution on a pro rata basis. However, like the equity receiver, the bankruptcy trustee's remedies against third parties are severely limited.

B. Claims Against Lawyers and Accountants

Claims against lawyers and accountants who represent the perpetrators of the Ponzi scheme are limited when brought by the receiver for the standing and *in pari delicto* reasons already identified. However, such claims may be available to the victims of the fraud without concern for standing and *in pari delicto*, so long as reasonable reliance and proximate causation can be proved. For example, the victims in the Black fraud sued Black's attorneys on a variety of claims arising from the attorneys' actions in facilitating the Ponzi scheme.[199]

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[196] SEC v. Black, No. 97-02257 (W.D. Pa. 1999) (original order prohibited filing an involuntary bankruptcy directed to Devon, FMS or Black). In contrast to the original Order entered in the *Black* receivership, the court in *Madoff* transferred the receivership case to bankruptcy court.

[197] The reason why the receiver decided to oppose the involuntary petition, after the district court permitted it, is obscure, at best.

[198] In the *Black* cases, some funds were not commingled and the investors who contributed those funds got all of their money returned. However, other victims of the fraud had commingled their investments and received approximately only 53% of the amount invested from the equity receivership. As a result, the commingled victims became the largest creditors of the bankruptcy estates of FMS and Devon when they were filed.

[199] Tyrone Area School District was represented by Black's lawyers and it brought a legal malpractice claim. None of the other school districts brought malpractice actions. The claims made by those districts included fraud, conspiracy, aiding and abetting fraud, and other similar claims based

The suit was brought in Pennsylvania state court, and after the complaint survived a dismissal motion,[200] the case settled after mediation.[201]

Accountants can be subject to similar claims. In the *Black* fraud, one school district sued its former outside accountants claiming that the audit should have found the fraud.[202] The school district hired an expert who found red flags of the Ponzi scheme which should have advised the accountant of the scheme before the district invested millions.[203] The case went to trial, and the jury awarded damages in favor of the school district, but the defense had used up virtually all of the accountant's insurance coverage.[204] The accountant's insurance did not provide substantial funds to the victims of the Ponzi scheme.[205] Furthermore, accountants may be held liable even though the primary perpetrator said that he did it all himself. Bernard L. Madoff's claim to have pulled off his multi-billion dollar swindle all by himself was ignored by the SEC when it sued his long time accounting aid, Daniel Bonventre, for falsifying records to disguise Madoff's fraud and illegally enrich himself.[206]

Sometimes the accountants are also victims of the fraud and not enablers. In the *Public Employees' Retirement Association of Colorado v. Deloitte & Touche LLP*,[207] there was a failure to plead a strong inference of scienter by the investors. Deloitte was the auditor for the parent company who inflated its earnings. The parent company concealed side letters from its accountants, who were deceived by their

upon the lawyers' creating paperwork for the fraudulent activities.

[200] In Pennsylvania, such a dismissal application is called "preliminary objections."

[201] Daniel Boone Area Sch. Dist. v. Kutak, No. 99-4899 (Pa. Com. Pl. Aug. 16, 2000) (opinion and order of dismissal) (Black's lawyer did not participate in the scheme as a principal perpetrator. Accordingly, the claims were made based on secondary theories of liability (e.g., aiding and abetting fraud, etc.)). Lawyers who participate in Ponzi schemes may also be subject to disciplinary proceedings. *See, e.g.*, Disciplinary Counsel v. Ulinski, 106 Ohio St. 3d 53 (2005). In *Ulinski*, the Supreme Court of Ohio permanently disbarred a lawyer who engaged in a Ponzi scheme which affected approximately 100 of his own clients and affected $41 million in investor funds. *Id.*

[202] School District of Daniel Boone v. Barbacane, Thornton Co., 759 A.2d 32 (Pa. Super. Ct. 2000).

[203] *Id.*

[204] Most professionals have insurance policies that include the cost of defense in the amount of coverage. As a result, the amount of coverage available to pay the judgment is reduced by defense cost.

[205] *Barbacane, Thornton Co.*, 759 A.2d 32.

[206] *Madoff Aide is Charged*, THE PHILADELPHIA INQUIRER, Feb. 26, 2010, at D2.

[207] 551 F.3d 305 (4th Cir. 2009).

client's repeated lies and artifices. Under these circumstances, the accountants were not liable to the victims who lost their investments. Instead, they were also victims.

Care must be taken to sue the professionals who may have provided services to the perpetrators of the fraud. Facts should be found to provide the basis to conclude that the professionals knew or recklessly acted in the fact of the red flags that a Ponzi scheme was afoot.

C. *Claims Against Banks*

In *Marion*,[208] banks that provided funds to the perpetrators of the Ponzi scheme to keep it going were found not to be liable to the equity receiver. But, the Third Circuit recognized that under certain circumstances a bank could be liable to the victims because the bank was either aware of the fraud or was willingly blind to it. Such a claim was made in *Bald Eagle Area School District v. Mid-State Bank and Trust Co.*,[209] where the bank participated in the fraud of the Ponzi scheme by holding the investments for Black on his entities and generating false accounting reports to be distributed by Black's entities to the victims of the fraud. The class action brought by school districts against the bank survived early preliminary objections to the complaint and certification of the class. When it looked as if the case would go to trial, it settled.

Read together, *Marion* and *Bald Eagle* hold that while banks may provide funding without being held liable, knowing or acting willingly blind to the fraud itself by a bank will result in a viable claim in favor of the victims of the Ponzi Scheme.

D. *Claims Against Stockholders and Security Advisors*

In one of the Black cases, the school district victims sued Lehman Brothers after they found out that Lehman had sold risky derivatives to Black and his companies using school district funds.[210] Lehman had

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[208] 591 F.3d 137.

[209] Nos. 98-516, 98-2603, 1999 WL 335059 (Pa. Com. Pl. Mar. 31, 1999).

[210] Daniel Boone Area Sch. Dist. v. Lehman Bros., Inc., 187 F. Supp. 2d 400, 402 n.4 (W.D. Pa. 2002). According to the Trustee's supplemental report, Black tried to avoid showing losses that he had suffered by trading in interest-rate-sensitive fixed income derivative securities. One type of derivative

inter-office memos indicating that it knew the use of such funds to buy derivatives was illegal under Pennsylvania law.[211] The action against Lehman in the United States District Court for the Western District of Pennsylvania ended with a settlement after discovery confirmed that Lehman knew about Black's fraud.[212]

Victims' action against stockholders and security advisers who enable Ponzi schemes are similar to any other securities fraud. However, if the stockholders and securities advisers are not perpetrators of the Ponzi scheme, but rather enablers or facilitators of the scheme, going against them may be more difficult to establish. In *Daniel Boone Area School District v. Lehman Brothers, Inc.*, the victims alleged that Lehman knew of Black's extensive losses in trading derivatives.[213] The allegations of the Complaint also alleged that a lawyer employed by Lehman questioned whether it was proper for Black to buy securities using school district funds.[214] Lehman continued to sell Black derivatives even though they were not authorized under Pennsylvania law.[215] Despite these compelling facts, the district court found no facts to hold Lehman liable for fraud, negligence per se, aiding and abetting a violation of the Pennsylvania Securities Act, aiding and abetting a breach of fiduciary duty, and tortious conduct in concert with others pursuant to Restatement (Second) of Torts Section 876(a).[216] With respect to claims of conspiracy between Black and Lehman Brothers, the court found the allegations of the Complaint sufficient.[217] The court ruled that because Black may be liable to the school district for selling

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security was a so-called "inverse floater" (the "EEN7"). SEC v. Black, No. 97-02257 (W.D. Pa. Mar. 10 1998) (trustee's supplemental report). While the trading value of the "EEN7" declined, Black increased the market value in his books, when there was nothing in the market to justify the change to cover other shortfalls in his "pooled accounts." *Id.* A substantial portion of Black's portfolio included a large number of interest-rate-sensitive securities with long maturities. *Id.*

[211] Lehman's participation in the conspiracy to defraud is shown chronologically in Appendix I and Appendix II to this Article. These chronologies are based upon discovery produced in the cases filed by the victims of the Ponzi scheme against third parties outside of the equity receivership. The interoffice memos were produced in discovery.

[212] Daniel Boone Area Sch. Dist. v. Lehman Bros., No. 01-745 (W.D. Pa. 2002) (order of October 7, 2005 and amended order of October 24, 2005).

[213] 187 F. Supp. 2d at 403.

[214] *Id.*

[215] *Id.*

[216] *Id.* at 404-10.

[217] *Id.* at 410-12.

derivatives knowing that such sales were unlawful, Lehman Brothers might be liable as a co-conspirator because it sold the derivatives to Black.[218] Moreover, the court noted that malice was properly pleaded because the allegations were that Lehman knew what Black was doing was illegal.[219]

XI. CONCLUSION

Without exception, the returns promised by Ponzi schemes are too good to be true. The perpetrators prey on the greed and avarice of investors to start the scheme and keep it going. The successful schemes make the tale told by the perpetrator appear reasonable. The money not used to repay early investors is used by the perpetrators to live a lavish lifestyle. Madoff used his money to "hob knob" with the rich and famous and to travel around the world. On the other hand, Black got into trouble by trying to continue his business when the financial conditions turned against his investing scheme and a legitimate business venture turned into a Ponzi scheme. In either scenario, the victims lost what they invested and never received what the tale promised. All they want back is their money.

Into the vacuum created by the victim's lost money steps the equity receiver. For most victims the promise of the equity receivership is that the receiver will find out what happened to their money and will recover it. However, the powers of the receiver are limited. They are intended to help in the investigation; they are not designed to maximize recovery from the perpetrators and all other entities or persons who helped the perpetrators. Some of the third parties did not know that they were involved in a Ponzi scheme. However, most of them knew or there were enough red flags that they should have realized it.

Virtually every Ponzi scheme has a perpetrator and assistants, such as lawyers, accountants, a bank and many times an investment banker. Since the perpetrator usually has dissipated his funds by the time the scheme is uncovered, the source of recovery for the victims lies with lawsuits against the third party assistants. But the equity receiver does not want to cooperate with counsel for the victims to pursue claims against the third parties in a prompt manner. Perhaps the reluctance is

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[218] *Id.* at 411.

[219] *Daniel Boone Area Sch. Dist.*, 187 F. Supp. 2d at 412.

due to a reasonable suspicion that some of the victims may, in fact, be perpetrators or third party assistants. However, that suspicion should be relieved early in the investigation, and the victims should be permitted to proceed with the cooperation of the equity receivership. In Black's Ponzi scheme, the lack of cooperation delayed recovery for four years. In Madoff's Ponzi scheme the length of time for a full recovery, if possible, may be even longer. In some Ponzi schemes, the failure of the equity receiver to cooperate with the victims and their counsel may prevent the maximum recovery possible.[220]

[220] Beginning in 2003, local governments throughout Pennsylvania used derivatives (known as "swaps" and "swaptions") to hedge variable-rate debt. This derivative use was permitted by Act 23 of 2003. However, after a number of school districts lost millions of dollars in the recent economic downturn, Pennsylvania is moving toward a prohibition of swap agreements because they are "too risky." The Auditor General of Pennsylvania believes that investments in all derivative securities should be banned. Michelle Kaske, *Deal In Focus: A Call to Stop Swaps*; Pennsylvania Plans Ban on Derivates, THE BOND BUYER, Feb. 1, 2010, at 1, 8-9.

APPENDIX I: ANALYSIS OF LEHMAN BROTHERS' INVOLVEMENT IN JOHN GARDNER BLACK THE PONZI SCHEME CONSPIRACY

Prelude to Lehman

According to the Trustee's Supplemental Report, filed in *Black*, in late 1993 and early 1994, competition in the investment advisory field for school districts' investments caused Black to reduce his fees and to guarantee rates of return.[221] To satisfy these guarantees, Black needed an investment instrument that could provide a higher rate of return than the traditional virtually risk free investments (i.e., U.S. Treasuries, etc.).[222] Black chose CMOs or collateralized mortgage obligations. Initially, Black's investments in CMOs were profitable, and as a result, FMS was profitable during the period January – April, 1994.[223] It appears that Black used the CMO investments through FMS to "burn the yield" to the school districts and avoid trouble with violations of the arbitrage regulations.[224] Black kept the excess yield for himself and made additional money.[225] However, on February 4, 1994, the Federal Reserve raised short term interests rates which reduced the value of all fixed rate investments, including CMOs.[226] FMS began to lose money in CMOs and/or was not generating enough profits or yield to cover his promises.[227] Black had to do something.

The following is what Black did in collusion with Mid-State, his banker, Kutak Rock, his lawyer, and Lehman, his prime investment banker:[228]

Oct. 1, 1993 Devon begins to guarantee rates of return to school districts

Jan. 1, 1994/April 1, 1993 FMS Net worth increases to $8 million from $500,000

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221 SEC v. Black, No. 97-02257 (W.D. Pa. Mar. 10 1998) (trustee's supplemental report).

222 *Id.*

223 *Id.*

224 *Id.*

225 *Id.*

226 *Id.*

227 *Black*, No. 97-02257 (trustee's supplemental report).

228 *Id.*

Feb. 4, 1994 Fed raises short term interest rates which diminished value of all fixed rate investments. Devon begins to lose money investing in CMOs.

Apr. 20, 1994 Black on behalf of Devon hires Lehman according to a one page letter from Devon to Lehman. In that letter,

- Black notifies Lehman of client authorizations for Mid-State Bank
- intent to place orders through Lehman and to promise indemnity and hold harmless to Lehman
- promise suitability to black's customers (the school districts) and hold harmless/indemnity if not suitable

May 1, 1994 Black begins to market CIAs or collateralized investment agreement to school districts. He believes that if he makes the transactions in derivatives one step away from the public bodies, he can avoid the question of illegality of investments in derivatives under the Pennsylvania School Code.

May 27, 1994 "Doomsday" involves the transfer of $192 million in cash and securities from individual accounts for Devon clients to a pooled custodian account at Mid-State Bank in the name of FMS; and

FMS buys (from a broker other than Lehman) an "inverse floater" (for the risk factors of "inverse floaters, see below") - - "FHR 1727 Inverse" (Federal Home Loan Mortgage Corp.)[229]

June 9, 1994 Lehman begins selling securities to the FMS Master pooled account for the first time. It is unclear if Lehman is selling derivatives to, or buying them from, the FMS pooled accounts.

Oct. 1994 Except for a brief period in 1996, this is the last time when there was no shortfall in the FMS pooled account. The shortfall caused the school districts to lose a portion of their original investments.

Nov. 25, 1994 According to FMS account statements, Lehman begins to sell derivatives to FMS Master Accounts.

Dec. 6, 1994 Orange County, CA files for bankruptcy after losses

[229] Prior to May 27, 1994, according to the Trustee's Supplemental Report, FMS purchased another inverse floater, from a broker other than Lehman and put it into the individual accounts of various school districts: FHLMC #1624-SA, Cusip Number 3133T2K74 (the "1624 SA Inverse"). *Id.* On Doomsday, FMS "bought" the various parts of the 1624-SA Inverse for the CIA's and put them into the FMS Master Pooled Account at Mid-State. *Id.* Eventually, FMS lost $6.5 million from its investment in the 1624-SA Inverse. *Id.*

of over $1 billion while trading in derivatives. Two days later, 12/08/94, state class actions filed. On 2/27/95, a federal class action was filed against Lehman after derivatives trading using Orange County's money. Lehman's reaction to the Orange County fiasco was to review all of its files for derivative trading using public money.

Lehman paid $825,000 in a partial settlement of the Orange County state class actions in August, 1996 (the total paid was over $4 million).

<u>Dec. 31, 1994</u> According to FMS account statements, Lehman only bought $12 million of derivatives by the end of the year.

By the end of the year, FMS had a shortfall in its Master Pooled Account at Mid-State Bank of $32 million. FMS also experienced unrealized losses in excess of $30 million.

<u>Feb, 1995</u> FMS sold the FHR1727 Inverse derivative to Lehman and realized a loss of more than $12 million. This is one of the top "25" trading losses appearing on Exhibit F to the Trustee's Supplemental Report. The trade appears in the 02/23/95 account statement from Lehman to FMS.

<u>Apr. 1, 1995</u> FMS has a shortfall of $55 million in its Market Value Net Position per Trustee's Supplemental Report. Nevertheless, for the rest of 1995, FMS continued to trade in derivatives and Lehman sold 100's of millions of dollars of derivatives to FMS during 1995.

<u>July 1, 1995</u> CIA liability exceeds net market value of collateral in FMS Pooled Account at Mid-State Bank by $56 million

<u>Oct. 12, 1995</u> FMS buys Treasury Strips from Lehman for a total of over $5.4 million

(This is an example of a derivative purchase from the FMS account statements.)

<u>Jan., 1996</u> On three separate days, FMS purchased the entire offering of an inverse floater known as EEN7 Inverse by the Trustee's Report for $14,130,000 from Lehman. Subsequently, Black manipulated the price and divided the investment to cover trading losses/shortfall. According to an audit response, the over-valued EEN7 was used to collaterize DBASD's investment in CIA's of over $19 million.

<u>Feb. 22, 1996</u> By this date, there had been 101 "buy" transactions per the account statements of Lehman to FMS totaling $363,364,94.03

Aug. 5, 1996 A letter from Black addressed to Lehman says Lehman is maintaining an account of Mid-State Bank, which is a custodian for school districts; discretionary authority for Mid-State Bank; Devon indemnifies and holds harmless Lehman for derivative trading.

Jan. 13, 1997 Last "buy" transaction between FMS & Lehman re: derivatives. Between 3/96 and this date, there were 77 transactions totaling $251,842.976.41.

Sept. 26, 1997 Devon/FMS shut down by SEC after surprise audit.

Dec., 1997 SEC Trustee sells EEN7 for $12 million at a loss of approximately $2 million. This is a trading loss which is not included in Exhibit "F" of the Trustee's Report, but it should be included in the damages since it was a component of the shortfall.

APPENDIX II: DEVON/FMS/LEHMAN TIMELINE

July, 1989 Devon is incorporated in MD

Dec., 1989 Devon registers with SEC as an investment advisor

Apr., 1992 FMS is incorporated in PA

Oct., 1993 Devon begins guaranteeing rates of return for School District clients

Apr., 1994 Devon and FMS become new Lehman customers; Several new Devon accounts are opened by Lehman over the next several months.

Apr., 1994 FMS' net worth increases to $8 million (from $500,000 at Jan., 1994)

May, 1994 Black markets his investment program to School Districts using CIA's entered into by Devon with FMS

May 27, 1994 "DOOMSDAY" according to former Devon employees, when Black begins the CIA program by transferring $192 million from Devon clients into a pooled custodian account in the name of FMS – the purchase was an "inverse floater"

Nov. 25, 1994 Lehman begins to sell derivatives with FMS

Feb., 1995 The inverse floater purchased May 27, 1994 is sold with realized losses of over $12 million

Apr., 1995 Net Market Value Position of FMS shows a shortfall of $55 million

July, 1995 CIA liabilities exceed collateral in FMS pool by $56 million. Losses in trading derivatives increases this amount to $70 million by Sept. 30, 1997

Oct. 12/Dec. 14, 1995 FMS buys U.S. Treasury Strips from Lehman totaling over $5.4 million

Nov. 1, 1995 Lehman higher-ups meet regarding questions on Devon's portfolio and derivative position. Derivative position as of Nov. 20, 1995 is 9% of total portfolio.

Jan. 9, 10 & 26, 1996 FMS purchases the entire offering of inverse floater security EEN7, steadily increasing its value in-house, while dipping rates do not support the changes in the "market value" – the difference between FMS' "value" of $82 million and the real market value of $12 million (according to Lehman) is a $70 million difference which is approximately the loss from the Ponzi scheme discovered by the equity receiver

Feb. 22, 1996 By this date, there had been 101 "buy" transactions between FMS and Lehman totaling over $363 million

Mar. 8 & 11, 1996 Kutak Rock personnel perform research on state statutes regarding permissible investments by political subdivisions

Apr., 1996 Lehman continues to sell derivatives to FMS

Apr. 30/May 1, 1996 Black's lawyers performs research on permissible state investments for entities; prepares, reviews and revises a memorandum on permitted state investments; and performs review of state statutes

June , 1996 Lehman continues to sell derivatives to FMS

June 28, 1996 Proceeds from 1995 TRAN are returned to DBASD at 5.86% rate as promised

July, 1996 Lehman continues to sell derivatives to FMS

Sept., 1996 Lehman continues to sell derivatives to FMS

Oct. 8, 1996 Black's lawyer reviews disclosure matters regarding ADV form after telephone conferences with client and Lehman

Oct., 1996 Lehman continues to sell derivatives to FMS

Jan. 13, 1997 Last "buy" transaction between FMS and Lehman re: derivatives. Between March, 1996 and this date, there were 77 transactions totaling close to $252 million

Aug., 1997 SEC examiners perform a surprise audit of John Gardner Black's records

Sept. 25, 1997 Lehman states that the valuation of the inverse floater FNR G92-032 32-S CMO Series 32 as of Jul. 31, 1997 was $1,435/hundred dollar unit and as of Aug. 29, 1997 was $1,364/hundred dollar unit

Sept. 26, 1997 SEC files a civil enforcement action against Black, Devon and FMS for violations of federal securities laws (U.S.D.C., W.D. Pa., C.A. No. 97-2257) – the TRO is granted, the assets are frozen, and Richard L. Thornburgh is appointed Trustee for Devon and FMS

July 6, 1998 Devon and FMS are placed into Chapter 7 Bankruptcy

July 6, 1998 Class Member losses total $78,659,477.32

Sept. 18, 1998 Involuntary bankruptcy petitions of Devon and

FMS are granted

June, 1999 A 134-count indictment is returned against Black with charges of mailing false statements to investors, inflating securities values, failing to disclose investment risks, etc.

Jan., 2000 Counsel for Class Members are made aware of Lehman derivative trades and knowledge that they were impermissible in Pennsylvania through witness statements (302's) of former Lehman personnel given to the FBI during Black's criminal investigation.