Golden Gate University Law Review

Volume 42
Issue 4 *Symposium: A Cross-Disciplinary Dialogue: White Collar Fraud, Asset Forfeiture, and Bankruptcy*

Article 6

8-8-2012

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ARTICLE

HANDLING CLAIMS IN PONZI SCHEME BANKRUPTCY AND RECEIVERSHIP CASES*

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INTRODUCTION

The end game for defrauded investors and other creditors in a Ponzi scheme case is the recovery of the maximum amount on their claims. Depending on whether the Ponzi perpetrator has landed in a bankruptcy case or a receivership proceeding, the rules governing the allowance and distribution priorities for claims filed in Ponzi scheme cases may vary. This Article discusses the treatment of the defrauded investor's claim in both bankruptcy and receivership cases. This Article also contrasts relatively rigid provisions in the Bankruptcy Code for the allowance, priority and distribution of claims in Ponzi scheme cases with the more flexible approaches that district courts in receivership proceedings have adopted. Finally, this Article discusses particular provisions under the Bankruptcy Code that may apply to other aspects of claims allowance, priority and distribution in a Ponzi scheme case.

In bankruptcy cases, Ponzi schemes bring unique issues to the claims allowance and distribution processes. Some of these issues can be

* Presented by Kathy Bazoian Phelps at: *A Cross-Disciplinary Dialogue: White Collar Crime, Asset Forfeiture and Business Bankruptcy* (Conference at the Golden Gate University School of Law, San Francisco, November 4-5, 2011).

This paper is partially derived and excerpted from Kathy Bazoian Phelps & Hon. Steven Rhodes, THE PONZI BOOK: A LEGAL RESOURCE FOR UNRAVELING PONZI SCHEMES (LexisNexis, March 2012), and is published here in this form with permission. For more information, go to: www.ThePonziBook.com.

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accommodated by the provisions of the Bankruptcy Code, while others are not addressed under the established statutory authority. Ponzi cases involve a variety of types of creditors rather than a pool of similarly situated general unsecured creditors, as in many other cases. For example, the defrauded investors in a Ponzi case may or may not be similarly situated. Some of those investors may assert claims for the recovery of their unpaid principal, others for their unpaid but expected profits, and yet others for both unpaid principal and profits, all depending on how much money they have been repaid throughout the Ponzi scheme. Meanwhile, trade creditors such as utilities or landlords seek payment for the services and goods they provided to enable the business to continue. Other creditors may assert breach of contract claims for the failure of the Ponzi perpetrator to provide promised funding because the Ponzi scheme collapsed. In equity, each of these different types of claims may call for unique treatment, but the Bankruptcy Code does not permit a trustee to consider them as distinct classes of creditors.

District courts presiding over receivership proceedings, on the other hand, are granted equitable powers to fashion relief on a case-by-case basis, unconstrained by the provisions of the Bankruptcy Code. The decisions resulting from Ponzi receivership cases reflect a variety of methodologies for establishing the priority of claims. These methodologies may differentiate between the principal and interest portions of the defrauded investors' claims, and may provide for differing treatment of prior distributions made to investors during the course of a Ponzi scheme.

The challenge for both a trustee and a receiver in distributing funds in Ponzi cases is to address and manage these varied interests within the confines of the Bankruptcy Code and the established methodologies used in Ponzi cases, while striving to distribute equitably the available cash, most if not all of which is likely derived from the defrauded investors' contributions into the fraudulent scheme.

I. Treatment of the Defrauded Investor's Claim

The principal challenges in administering defrauded investors' claims in a Ponzi case are: (1) how to determine the allowable amount of the claim, taking into consideration the distinction between the unpaid principal portion of the claim and the unpaid expected profits portion of the claim; and (2) how to treat payments previously made to the claimant during the course of the Ponzi scheme.

A defrauded investor in a Ponzi scheme will likely assert a claim for all amounts invested and not repaid plus the amount of unpaid fictitious profits that were promised or that may be reflected in a statement of account. A trustee or receiver, seeking both to maximize the returns to all creditors and to equalize the distributions to all investors, will likely seek to disallow promised fictitious profits and to reduce the investor's claim by setting off the claim amount by the total amount distributed to the claimant during the course of the Ponzi scheme. For example, an investor who has invested $100,000 for one year with a promised return of 10% per month and who has been repaid $50,000 over a five month period might assert a claim for the principal invested of $100,000 plus the unpaid promised returns for the 7 remaining months of $70,000, for a total of $170,000. A trustee or receiver, on the other hand, will likely assert that the $50,000 paid to the investor during the Ponzi scheme was a return of principal, and that the only amount owing is the balance of the unreturned principal, or $50,000. The differentiation between principal amounts invested and expected fictitious profits, therefore, becomes critical in Ponzi schemes in the claims allowance and distribution process.

A. THE INVESTOR CLAIM UNDER THE BANKRUPTCY CODE

Under the Bankruptcy Code, there is a question whether trustees have any leeway in distinguishing between a claim for unreturned principal and a claim for expected fictitious profits. The Bankruptcy Code has no separate priority or allowance provisions that expressly permit such a distinction, as discussed in section II of this Article. Nevertheless, relying on principles of equity, some bankruptcy courts have permitted a trustee to make such a distinction, to bifurcate claims, and to disallow or subordinate the expected profits portion of the investor's claim. The court in *In re Taubman*, for example, held:

> Based upon the express equitable powers entrusted to the bankruptcy court, see 11 U.S.C. §§ 105, 502(b)(1), 502(j), and 510(c)(1), and, based upon the foregoing applicable case law, the court concludes that equity dictates that the proofs of claim be split into an "A" portion and a "B" portion. The "A" claim represents on a cash-in/cash-out basis the difference, if any, between what an investor actually invested, lent, or gave to the Debtor, *minus* the total he or she received back at any time. The "B" portion consists of all profit, interest, return of principal, punitive damages, multiple damages, or any amount in excess of actual pecuniary loss. The "B" claims shall receive distribution only after all "A" claims have been paid in full.[1]

[1] *In re* Taubman, 160 B.R. 964, 982 (Bankr. S.D. Ohio 1993).

Other courts have similarly held that it is not equitable to include fictitious profits in the claim amount. For example, the court in *Official Cattle Contract Holders Committee v. Commons* (*In re Tedlock Cattle Co.*) held that the trustee could use an "equitable" theory to exclude profits in claim calculation rather than use a "benefit-of-the-bargain" theory.[2]

Additionally, the court in *Abrams v. Eby* (*In re Young*) held that a claimant could not share in the remaining funds until he had accounted for his profits and that allowing a claim for both false profits and the original investment would not be equitable because the profits had been paid at the expense of the other equally innocent investors in the fund.[3] The court noted:

> We have, then, a common enterprise, a common fund, contributed by all the customers, a manager common to all, his breach of trust common to all, losses common to all. It follows that all sums paid as profits to one adventurer from the common fund, when there was no profit, was an unjust enrichment of that adventurer from the fund belonging to all in common, sufficient to pay but a small dividend on the capital sums actually paid in. Equity therefore requires that he should account for all sums paid to him as profit before he can share with others in the application of the funds on hand to the debts due for sums actually paid in.[4]

The court in *Lustig v. Weisz & Associates, Inc.* (*In re Unified Commercial Capital*), in analyzing Bankruptcy Code section 548 and whether reasonably equivalent value is exchanged for the return of principal, first noted that, "The simple fact is that the use of funds for a period of time has value."[5] In other words, the court observed that it could be appropriate to recognize the time value of the use of funds. Nevertheless, the court then went on to discuss why the allowance of a claim for fictitious profits may not be appropriate in a Ponzi scheme case:

> In the context of false profits, there may be some logic to such a distinction between transfers of principal and of amounts in excess of principal. If a person invests money with the understanding that he will share in the profits produced by his investment, and it turns out

[2] Official Cattle Contract Holders Comm. v. Commons (*In re* Tedlock Cattle Co., Inc.), 552 F.2d 1351, 1353 (9th Cir. 1997).

[3] Abrams v. Eby (*In re* Young), 294 F. 1 (4th Cir. 1923).

[4] *Id.* at 4.

[5] Lustig v. Weisz & Assocs., Inc. (*In re* Unified Commercial Capital), Nos. 01–MBK–6004L, 01–MBK–6005L, 2002 WL 32500567, at *8 (W.D.N.Y. June 21, 2002).

> that there are no profits, it is difficult to see how that person can make a claim to receive any more than the return of his principal investment. The false representation by the Ponzi schemer that he is paying the investor his share of the profits, which are in fact nothing more than funds invested by other victims, cannot alter the fact that there are no profits to share.[6]

The *Unified Commercial Capital* court reconciled its two viewpoints that: (1) interest should compensate for the use of money, but that (2) false profits should not be paid in a Ponzi scheme, by finding that, under the facts of the case before the court, "the payments to Associates were not simply payments of nonexistent profits, but of a contractually provided-for, commercially reasonable rate of interest on what amounted to a loan by Associates to Unified."[7]

Thus, depending on the facts of a case and the court's view of the legitimacy of the payment of interest or profits in a Ponzi case, a trustee may be permitted to bifurcate an investor's claim in the claim allowance and distribution process in a bankruptcy case, and pay actual pecuniary loss before expected profits, punitive damages, or other amounts in excess of the actual pecuniary loss. Such bifurcation is not expressly provided for under the Bankruptcy Code, however, and is up to the discretion of the bankruptcy court.

In addition to determining whether unpaid fictitious profits should be allowed as part of a defrauded investor's claim, a court must determine how to account for payments that were made to the investor during the course of the Ponzi scheme. In this regard, the Bankruptcy Code provides some limited guidance and leeway for a trustee to seek disallowance of claims. Section 502(d), discussed more fully in Section II of this Article, provides that an investor's claim may be disallowed unless and until a voidable transfer is returned to the estate.[8] Thus, if an investor does not return an avoided transfer, then any remaining claim by the investor will be disallowed. If, however, the investor does return the avoided transfer, then the claimant may file a claim or amend a previously filed claim to include the amounts disgorged to the trustee.

[6] *Id.*

[7] *Id.* The court supported this finding by noting that the debtor "represented that it was selling 'debentures' and 'certificates of deposit' to investors with 'guaranteed' returns of twelve percent or more annually." *Id.* On typical Ponzi facts, the court was unwilling to apply an across the board rule and policy judgment that in Ponzi cases there is not necessarily no value given in exchange for the use of money. The court concluded that this was a "legal fiction" and a policy decision "that should be made by Congress." *Id.* at *5-6.

[8] 11 U.S.C.A. § 502(d) (Westlaw 2012).

Nevertheless, as otherwise discussed in this Article, a claim for fictitious profits or interest may not ultimately be allowed in the case.

B. THE INVESTOR CLAIM IN RECEIVERSHIP PROCEEDINGS

In receivership proceedings, the district court sits in equity and has "the authority to approve any plan provided it is 'fair and reasonable.'"[9] A receiver's distribution plan may, therefore, distinguish between different types of claimants and provide for different treatment for different classes of investors.[10] For example, a distribution plan may seek to limit distributions to those claimants who suffered actual out-of-pocket losses.[11] Or, differing treatment may be sought for distributions to investors in contrast to trade creditors.[12] In *CFTC v. Capitalstreet Financial, LLC*, the court approved a higher priority for defrauded investors as compared to non-investor general creditors, without explanation of its decision, as follows:

> The Receivership Estate shall be distributed in the following order:
>
> A. To claims for expenses of the administration of the Receivership Estate, including legal and accounting fees; expenses to preserve the value of assets; and costs of realization and payment of any taxes due on property or income of property of the Receivership Estate incurred during the pendency of the receivership (the "Administrative Claimants");
>
> B. To the return of investments to Investors; and
>
> C. To any General Creditors, should any assets remain in the Receivership Estate.[13]

There is very limited statutory authority governing claims allowance and distribution in regulatory receivership cases. Courts presiding over receivership and SIPA[14] proceedings have developed a range of

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[9] S.E.C. v. Byers, 637 F. Supp. 2d 166, 174-75 (S.D.N.Y. 2009) (quoting S.E.C. v. Wang, 944 F.2d 80, 81 (2d Cir. 1991)).

[10] S.E.C. v. Wang, 944 F.2d 80, 84 (2d Cir. 1991).

[11] S.E.C. v. Certain Unknown Purchasers, 817 F.2d 1018, 1021 (2d Cir. 1987).

[12] *See, e.g.*, Nw. Bank Wisc., N.A. v. Malachi Corp., 245 Fed. App'x 488, 495 (6th Cir. 2007).

[13] U.S. Commodity Futures Trading Comm'n v. Capitalstreet Fin., LLC, No. 3:09cv387–RJC–DCK, 2010 WL 2572349, at *2 (W.D.N.C. June 18, 2010); *see also* S.E.C. v. HKW Trading LLC, No. 8:05–cv–1076–T–24–TBM, 2009 WL 2499146 (M.D. Fla. Aug. 14, 2009).

[14] In 1970, Congress created the Securities Investor Protection Corporation (SIPC), a nonprofit corporation to which most registered broker-dealers are required to belong. *See* 15

methodologies to account for withdrawals made by investors during a Ponzi scheme. In contrast to a trustee in a bankruptcy case, a receiver may craft and propose a distribution plan that classifies claims in a manner specific to the facts of a particular case and based on equitable considerations.[15]

In receivership cases, courts adopting different methodologies regarding claim allowance and distribution priorities have addressed the competing needs of the differing categories of investors. These competing interests are summarized as follows:

> (1) Net winner investors who were paid profits on top of the return of their principal investment: (a) seek to retain to profits already paid to them; and (b) may file claims for all expected but unpaid profits as reflected on their last account statement received from the Ponzi debtor.
>
> (2) Net loser investors who received something, but less than the full amount of their principal: (a) seek to retain to distributions already paid to them; and (b) may file claims for additional amounts of both unpaid principal and expected profits.
>
> (3) Net loser investors who received nothing: (a) find it unfair that other investors can retain any prior distributions made to them; and (b) want the receiver to seek disgorgement of all amounts paid to other investors so that all investors can be treated on an equitable *pro rata* basis.
>
> (4) Receivers, faced with the task of maximizing the pot available for distribution, must balance allowance and distribution issues with their avoiding power rights to bring back into the estate prior distributions made to some investors. They, therefore, seek to reduce investor claims by the amounts of distributions previously made to the investors and, under fraudulent transfer law or other legal theories, may seek to recover interest and principal paid to investors.

U.S.C.A. § 78ccc (Westlaw 2012). "SIPC insures investors who deposit cash or securities with a broker against the risk of broker insolvency." SIPC v. Pepperdine Univ. (*In re* Brentwood Sec., Inc.), 925 F.2d 325, 327 (9th Cir. 1991).

[15] *See, e.g.*, S.E.C. v. Enter. Trust Co., 559 F.3d 649, 652 (7th Cir. 2009); Official Comm. of Unsecured Creditors of WorldCom, Inc. v. S.E.C., 467 F.3d 73, 81 (2d Cir. 2006) (noting that district courts have broad authority to craft remedies for securities violations); S.E.C. v. Basic Energy & Affiliated Res., Inc., 273 F.3d 657, 668 (6th Cir. 2001); S.E.C. v. Forex Asset Mgmt. LLC, 242 F.3d 325, 331 (5th Cir. 2001) ("[I]n shaping equity decrees the trial court is vested with broad discretionary power." (internal quotation marks and citation omitted)); S.E.C. v. Hardy, 803 F.2d 1034, 1037-39 (9th Cir. 1986).

In order to accommodate these competing interests, courts have approved different methodologies for allowing and making distribution on investor claims, which are summarized below.

1. Last Statement Method

The Last Statement Method allows claims based upon the amounts identified on the last statement generated on the customer's account.[16] The Last Statement Method, although not widely adopted, is a favorite of investors who have accumulated profits on their statements and who seek to be paid those expected profits. In *CFTC v. Richwell*, the court approved a plan that distributed remaining assets to existing investors "*pro rata* on the basis of the lesser of (a) current account balance . . . and (b) their total net deposits into their margin account."[17] Customers who had made profits would be entitled to their entire initial investment, while those who had suffered losses would be limited to what remained in their accounts. The *Richwell* court approved the receiver's plan because, within its broad discretion, it concluded that it was the most equitable compromise, because the company had detailed accounting records that made it straightforward to segregate customer accounts.[18]

2. Net Investment Method

Many courts have adopted the "cash in/cash out" or "net investment" methodology in fixing the amount of investor claims. The Net Investment Method credits the amount of cash deposited by the customer into his or her account and deducts any amounts withdrawn from it.[19]

The Net Investment Method and the Last Statement Method are the two competing methodologies used to calculate "net equity" in SIPA proceedings for purposes of determining the customer's claim amount pursuant to SIPA section 78*lll*(11).[20] In the *Madoff* case, the court

[16] Commodities Futures Trading Comm'n v. Richwell Int'l, Ltd., 163 B.R. 161 (Bankr. N.D. Cal. 1994).

[17] *Id*. at 162 (footnote omitted).

[18] *Id*. at 163-64.

[19] *In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011).

[20] 15 U.S.C.A. § 78*lll*(11) (Westlaw 2012); SIPA § 78*lll* (11) defines "net equity" as:

> [T]he dollar amount of the account or accounts of a customer, to be determined by—
>
> (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date—
>
> (i) all securities positions of such customer . . . ; minus

approved the Net Investment Method to determine a customer's net equity.[21] That court summarized its rationale in affirming the Net Investment Method over the Last Statement Method as follows:

> The statutory definition of "net equity" does not require the Trustee to aggravate the injuries caused by Madoff's fraud. Use of the Last Statement Method in this case would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations.[22]

3. Modified Net Investment Methodology

Some courts have modified the Net Investment Method, referring to it as the "Modified Net Investment Method."[23] In *CFTC v. Barki, LLC*, the court described the Modified Net Investment Method as follows, "[T]he investors could retain their withdrawn 'profits' but would receive a *pro rata* share based on the sum of their initial investments and the 'illusory profits' that were never withdrawn from the account *minus* the profit distribution . . . ."[24]

This methodology differs from the Net Investment Method, whereby "the investors could retain their [withdrawn] 'profits' but would receive a *pro rata* share based on their initial investments *minus* the profit distribution, *i.e.*, profits would be subtracted before determining the investor's *pro rata* shares."[25] In other words, under the Net Investment Method, if an investor had invested $100,000 with a promised interest rate of ten percent per month and been repaid $50,000, the claim would be allowed at the difference of the money in ($100,000) and the money out ($50,000), for a total of $50,000. Under the Modified Net Investment, the same investor's claim would be allowed at the amount of the difference of the initial investment plus expected profits (i.e., $100,000 investment plus assumed one year expected profits of $120,000 for a total of $220,000) less the money out ($50,000) for a total of $170,000.

(B) any indebtedness of such customer to the debtor on the filing date . . . .

15 U.S.C.A. § 78*lll*(11).

[21] *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229.

[22] *Id.* at 235.

[23] *See, e.g.*, U.S. Commodities Futures Trading Comm'n v. Barki, LLC, No. 3:09 CV 106–MU, 2009 WL 3839389, at *2 (W.D.N.C. Nov. 12, 2009); S.E.C. v. Byers, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009).

[24] *Barki, LLC*, 2009 WL 3839389, at *1.

[25] *Id*.

4. Rising Tide Method

The general concept of the Rising Tide Method is that all investors should, in equity, receive an equal percentage distribution on their lost investments, considering both the prior payments from the Ponzi perpetrator and the distributions to be made from the estate. "Payments received by the claimant prior to the Ponzi Scheme's collapse are treated as 'distributions' on par with the distributions to be made by the Receiver, so that prior amounts paid by [the debtor] are credited against the amount that would otherwise be paid from the Receiver Estate."[26] As explained in *CFTC v. Equity Financial Group, LLC*, "Under this method, investors are permitted to retain previously received funds, but those withdrawals will be credited against the investors' respective *pro rata* shares calculated based on the full amounts invested."[27]

Several courts have attempted to describe the Rising Tide Method, with varying degrees of usefulness. The *Equity Financial* court simply explained that distributions under the Rising Tide Method are "calculated according to the following formula: (actual dollars invested x *pro rata* multiplier) - withdrawals previously received = distribution amount."[28]

In *Parish*, the court described the Rising Tide Method as follows:

> In effect, an individual investor's loss is deemed to be the gross amount actually invested in the scheme. Payments received by the investor prior to the scheme's collapse are treated as "distributions" on par with the distributions to be made by the Receiver, so that prior amounts paid by Parish are credited against (i.e., subtracted from) the amount that would otherwise be paid from the receivership estate. Under this method, investors who received prior payments are entitled to receive a smaller *pro-rata* payment from the receivership estate than those who received no prior payment. Moreover, investors who previously received payments exceeding their *pro rata* amount of the total distribution will receive no distribution from the receivership estate.[29]

In *In re Receiver*, the court adopted the receiver's proposed formula:

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[26] *In re* Receiver, No. 3:10–3141–MBS, 2011 WL 2601849, at *2 (D.S.C. July 1, 2011).

[27] Commodities Futures Trading Comm'n v. Equity Fin. Grp., LLC, No. Civ.04-1512 RBK AMD, 2005 WL 2143975, at *24 (D.N.J. Sept. 2, 2005).

[28] *Id.*

[29] S.E.C. v. Parish, No. 2:07–cv–00919–DCN, 2010 WL 5394736, at *3 (D.S.C. Feb. 10, 2010).

> (Amount to Distribute) DIVIDED BY (Total Actual Deposits made by all allowed Claimants) MULTIPLIED BY (the Actual Deposit associated with each Claim) MINUS (Actual Return associated with each Claim).[30]

All of these methodologies for allowance and distributions can and have been considered equitable, depending on the facts of the particular case and the court's evaluation of the distributions under the several methodologies.[31] In *Lake Shore*, the court stated,

> The propriety of using the "Net Investment" method, however, does not turn on whether mathematically, a group of investors will lose more under the "Rising Tide" method than other investors will gain. Instead, as discussed above, the court must determine which method is equitable given the facts and circumstances of this case.[32]

C. TREATMENT OF ROLLED OVER DISTRIBUTIONS

In both bankruptcy and receivership cases, one other area of debate in calculating claims in Ponzi cases is whether to give credit to investors for distributions that they rolled over from fictitious profits as a new investment.[33] For example, where an investor has accumulated fictitious profits on account of its investment in the Ponzi scheme, that investor could either withdraw those "profits" or roll them over into the investment account to be treated as additional principal invested. The objection to the treatment of the profits as an additional principal investment is that credit for such rollover is inequitable because the profits that were rolled over were illusory and, in essence, not a real investment.[34] On the other hand, the claimants contend that if had they not rolled over the investment, they would have withdrawn those profits and, "Ignoring the rolled-over amount, as the objectors propose, would further penalize those investors who chose to roll over their investments rather than receive them in cash. Such a result would be inequitable."[35]

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[30] *In re Receiver*, 2011 WL 2601849, at *3.

[31] U.S. Commodities Futures Trading Comm'n v. Barki, LLC, No. 3:09 CV 106–MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009).

[32] U.S. Commodity Futures Trading Comm'n v. Lake Shore Asset Mgmt. Ltd., No. 07 C 3598, 2010 WL 960362, at *10 (N.D. Ill. Mar. 15, 2010).

[33] *See, e.g.*, S.E.C. v. Byers, 637 F. Supp. 2d 166, 183 (S.D.N.Y. 2009) (permitting a credit for the amounts rolled over as new investments).

[34] *Id.* at 182.

[35] *Id.* at 183.

In *SEC v. Byers*, the court approved a distribution plan that included the rolled over distributions as an additional investment of principal:

> The Plan also proposes that any distributions investors chose to roll over into the funds—rather than receive in the form of cash—be added to the baseline amount for calculating their distribution under the Plan. In other words, the Plan would treat a rolled-over distribution as an out-of-pocket loss. The following examples illustrate the proposal:
>
> Investor A had a gross investment of $ 100,000. Rather than take a cash distribution, he rolled over $ 20,000 back into his Wextrust investment. His net investment amount would be $ 120,000. Assuming a pro rata multiplier of 10%, Investor A's distribution would be $ 12,000.
>
> Investor B had a gross investment of $ 100,000. Investor B took a cash distribution of $ 20,000 at one point, and later rolled over $ 50,000. Her net investment amount would be $ 130,000. Assuming a pro rata multiplier of 10%, Investor B's distribution would be $ 13,000.[36]

II. OTHER PRIORITY AND DISTRIBUTION ISSUES UNDER THE BANKRUPTCY CODE

Although the Bankruptcy Code does not contain any provisions that specifically address Ponzi schemes or the allowance and priority of investor claims that are incurred in connection with a Ponzi scheme, the Bankruptcy Code has application to other aspects of claims allowance, priority and distribution which might apply in a Ponzi scheme case.

A. TEN CATEGORIES OF PRIORITY CLAIMS

Section 507 of the Bankruptcy Code[37] sets forth an ordered scheme containing ten categories of claims entitled to priority in a bankruptcy case.[38] None of these ten categories relate specifically to claims in Ponzi

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[36] *Id.*

[37] 11 U.S.C.A. § 507 (Westlaw 2012).

[38] The ten categories of claims under 11 U.S.C. § 507 are summarized as follows:

(a)(1): Domestic support obligations
(a)(2): Administrative expenses allowable under § 503(b)
(a)(3): Gap period claims allowed under § 502(f)
(a)(4): Claims for wages, salaries and commissions
(a)(5): Employee benefit plan contributions
(a)(6): Claims by grain producers and United States fishermen
(a)(7): Consumer deposits

cases. The second of the priority claims set forth in section 507, for administrative expenses under section 503, however, may be relevant in a Ponzi case.[39] A little-used provision of section 503(b), subparagraph (3)(C), may offer defrauded investors some relief, to the extent they assisted in the criminal prosecution of the Ponzi perpetrator. The third priority for administrative claims pursuant section 503(b)(3)(C) provides for reimbursement of expenses incurred by a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor.[40] Accordingly, a creditor active in the assistance of the prosecution of a criminal case against the Ponzi perpetrator may be entitled to administrative expense priority for its costs. Under that section, a creditor is not required to show that the expenses provided a benefit of the estate, but must show a direct relationship between the expenses sought and the criminal prosecution.[41] The creditor must also prove that the prosecution of the criminal offense relates to the debtor's case, business or property.[42] This provision would not, however, appear to elevate the creditor's Ponzi scheme losses themselves to priority status.

B. CHANGING PRIORITIES[43]

While sections 503 and 507 establish clear priorities for different categories of claims, those priorities can be altered by other sections of the Bankruptcy Code that may impact the manner in which interest is

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(a)(8): Tax obligations and customs duties
(a)(9): Commitments to regulatory agencies
(a)(10): Drunk driving claims

11 U.S.C.A. §§ 507(a)(1)-(10) (Westlaw 2012).

[39] 11 U.S.C.A. § 503 (Westlaw 2012).

[40] Section 503(b)(3)(C) states that an administrative expense shall be allowed for "the actual, necessary expenses . . . incurred by . . . a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor." 11 U.S.C.A. §503(b)(3)(C) (Westlaw 2012).

[41] Lebron v. Mechem Fin. Inc., 27 F.3d 937, 943 n.1 (3d Cir. 1994).

[42] *In re* Summit Metals, Inc., 379 B.R. 40, 59 (Bankr. D. Del. 2007) (disallowing expenses under §503(b)(3)(C) because the criminal case against the debtor's principal did not relate to the debtor's case, property, or business).

[43] The Bankruptcy Code contains provisions other than those discussed in this Article which may have the effect of changing priorities of claims in a bankruptcy case, but which are not particularly applicable to a Ponzi scheme case. For example, § 506(c) relates to a trustee's ability to surcharge a secured creditor's collateral for the costs of preserving the creditor's collateral; § 724(a) permits a trustee to avoid tax and judgment liens that secure claims for noncompensatory tax penalties and punitive damages; and §724(b) provides for subordination of certain types of unavoidable tax liens to other types of claims, including administrative, wage and other priority claims.

treated and the priority of claims vis-à-vis one another. A few of the provisions of the Bankruptcy Code that may have an impact in Ponzi schemes are discussed below.

1. Disallowing Claims Under Section 502(b)

Section 502(b) [44] sets forth six categories of claims that may be disallowed as of the date of the filing of the petition. Although most of these provisions may not have direct application in a Ponzi case, section 502(b)(2) may have the effect of leveling the playing field post-petition for all categories of investors, irrespective of their promised interest rate and irrespective of when they first invested in the fraudulent scheme. Section 502(b)(2) suspends the accrual of interest on claims as of the date of the filing of the petition.[45] It is applied uniformly to all categories of investors in a Ponzi scheme. Some investors, referred to as "net winners," may have invested early in the scheme and been paid back both the principal originally invested plus some of the promised fictitious interest on top of the returned principal sum. Those net winner investors may, however, still claim unpaid promised interest at the time of the filing of a bankruptcy petition. Other investors, referred to as "net losers," recovered something less than the full amount of their investment in the scheme and continue to claim unpaid principal plus unpaid interest at the time of the petition. An investor's claim for expected profits or "interest" will be cut off as of the petition date, regardless of whether the investor is a net winner or net loser because section 502(b) generally prohibits payment of post-petition interest on pre-petition unsecured claims.

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[44] The six categories of claims under 11 U.S.C. § 502 are summarized as follows:

> (b)(1): such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;
> (b)(2): such claim is for unmatured interest;
> (b)(3): if such claim is for a tax assessed against property, such claim exceeds the value of the interest of the estate in such property;
> (b)(4): if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services;
> (b)(5): such claim is for a debt that is unmatured on the date of the filing of the petition and that is excepted from discharge under section 523(a)(5) of this title; and
> (b)(6): if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property.

11 U.S.C.A. §§ 502(b)(1)-(6) (Westlaw 2012).

[45] Interest is "unmatured," within the meaning of section 502(b)(2) if it was not yet due and payable at the time the debtor filed its bankruptcy petition. *In re* Thrifty Oil Co., 249 B.R. 537 (Bankr. S.D. Cal. 2000), *aff'd*, 322 F.3d 1039 (9th Cir. 2003).

The rationale for suspending the accrual of interest as of the petition date is based on the concept of equality of distribution. "[T]he rule prevents any unmerited gain or loss by creditors whose claims have different interest rates or who are paid at different times by the bankruptcy court; all are treated equally."[46] Although courts may struggle with how to calculate the allowable amount of an investor's claim, as set forth in section II of this Article, the issue of whether to permit a claim for post-petition interest is fixed by statute and is not subject to debate.

There are, however, a few exceptions to this rule. First, in the rare event that an estate is solvent, post-petition interest may be paid to unsecured creditors pursuant to section 726(a)(5).[47] Second, an over-secured creditor may add post-petition interest to the amount of its claim to the extent of the over-security.[48] Third, post-petition interest may be allowed if a secured creditor holds collateral that yields interest, dividends or other income, so that this income may be applied to the payment of interest accruing on the debt after the date of the filing of the petition.[49]

2. *Disallowance of Claim of Transferee of Avoidable Transfer Under Section 502(d)*

Section 502(d) may also come into play in a Ponzi case to alter the priorities of claims. That section states, "the court shall disallow any claim of any entity . . . that is a transferee of a [voidable] transfer."[50] This section may lead to the disallowance of investor claims in a Ponzi case, and thereby alter the ultimate distribution to creditors. Trustees commonly bring fraudulent transfer claims in Ponzi cases under section 548 or applicable state law to seek the return of fictitious profits paid to investors, and sometimes to seek the return of principal repaid to investors.[51] To the extent that such a voidable transfer has been made to

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[46] *In re* Fesco Plastics Corp, Inc., 996 F.2d 152, 155 (7th Cir. 1993).

[47] 11 U.S.C.A. § 726(a)(5) (Westlaw 2012).

[48] United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (*In re* Timbers of Inwood Forest Assocs., Ltd.), 484 U.S. 365, 370 (1988); Bondholder Comm. v. Williamson Cnty. (*In re* Brentwood Outpatient, Ltd.), 43 F.3d 256 (6th Cir. 1994).

[49] Sexton v. Dreyfus, 219 U.S. 339 (1911); *In re* Jenson, 980 F.2d 1254, 1259 (9th Cir. 1992) (secured claim which included post-petition interest earned on funds held pursuant to prejudgment writ of attachment represented allowable post-petition appreciation of the collateral rather than unmatured interest).

[50] 11 U.S.C.A. § 502(d) (Westlaw 2012).

[51] Courts generally find that the return of principal is not recoverable as a fraudulent transfer because reasonably equivalent value is exchanged by the investor for the return of principal under a restitution claim theory. *See, e.g.*, Donell v. Kowell, 533 F.3d 762, 772 (9th Cir. 2008); *but see*

an investor and is not returned, any claim filed by that transferee must be disallowed under section 502(d).[52] In *Picard v. Estate of Chais* (*In re Bernard L. Madoff Investment Securities LLC*), the court applied section 502(d) to a SIPA claim as well because "a net equity claim is not a claim against SIPC, but rather a claim against the pool of customer property collected by the Trustee."[53]

A trustee may use section 502(d) in connection with avoidance power rights under sections 547 (preferential transfers), 548 (fraudulent transfers), 549 (unauthorized post-petition transfers), and 550 (recovery, preservation and subsequent transferees), as well as when a trustee has obtained a turnover order under section 542, or when a set off is avoidable under section 543. In a Ponzi case, it is conceivable that a trustee may bring claims under any of these Bankruptcy Code sections seeking to recover property transferred by the Ponzi perpetrator either pre- or post-petition, and the trustee may seek to disallow that claim the extent that creditor fails to return the avoidable transfer to the estate.

3. Changing Priorities by Subordination of Claims

The order of priority of claims can further be altered by subordinating certain types of claims to others. Subordination alters the otherwise applicable priority of that claim such that the subordinated claim receives distribution only after the senior claims to which it has been subordinated have been satisfied in full.

Section 510 provides for three types of subordination: (1) by agreement (section 510(a)); (2) for claims arising out of certain securities transactions (section 510(b)); and (3) equitable subordination (section 510(c)).[54]

Equitable subordination under section 510(c) may occur in Ponzi cases where one claimant has engaged in inequitable conduct that results in injury to other creditors. "Equitable subordination allows the

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Picard v. Estate of Chais (*In re* Bernard L. Madoff Inv. Sec. LLC), 445 B.R. 206, 225 (Bankr. S.D.N.Y. 2010) ("Only innocent investors who reasonably believed that they were investing in a legitimate enterprise are entitled to claims for restitution.").

[52] 11 U.S.C.A. § 502(d) (Westlaw 2012).

[53] *In re Bernard L. Madoff Inv. Sec. LLC*, 445 B.R. at 239; *see also* Picard v. Madoff (*In re* Bernard L. Madoff Inv. Sec. LLC), 458 B.R. 87, 120-21 (Bankr. S.D.N.Y. 2011).

[54] 11 U.S.C.A. § 510 (Westlaw 2012).

bankruptcy court to reprioritize a claim if it determines that the claimant is guilty of misconduct that injures other creditors or confers an unfair advantage on the claimant."[55] Thus, claims can be reprioritized based on the wrongful conduct of a claimant.

In determining the appropriateness of equitable subordination, courts have nearly uniformly applied the standards established by the Fifth Circuit in *Benjamin v. Diamond* (*In re Mobile Steel Corp.*).[56] The elements considered by courts in finding that a claim should be subordinated are: "(i) [t]he claimant must have engaged in some type of inequitable conduct[;] (ii) [t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant[;] (iii) [e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act."[57]

A court may equitably subordinate a claim "notwithstanding the apparent legal validity of a particular claim [where] the conduct of the claimant in relation to other creditors is or was such that it would be unjust or unfair to permit the claimant to share *pro rata* with the other claimants of equal status."[58] A recent bankruptcy fraud case illustrates this principle. In *Committee of Unsecured Creditors of Adelphia Communications Corp. v. Bank of America* (*In re Adelphia Communications Corp.*), the court noted:

> Inequitable conduct is that conduct which may be lawful, yet shocks one's good conscience. It means, inter alia, a secret or open fraud, lack of faith or guardianship by a fiduciary; an unjust enrichment, not enrichment by bon chance, astuteness or business acumen, but enrichment through another's loss brought about by one's own unconscionable, unjust, unfair, close or double dealing or foul conduct.[59]

In that case, the creditors' committee alleged that the debtors' banks and investment bankers were sued for their conduct in allegedly assisting the debtors in conducting a fraud to the disadvantage of other creditors. The court denied the defendants' motion to dismiss, finding that there were factual issues whether "the Defendants 'knowingly or recklessly'

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[55] *See In re* Kriesler, 546 F.3d 863, 865-66 (7th Cir. 2008).

[56] Benjamin v. Diamond (*In re* Mobile Steel Corp.), 563 F.2d 692, 700 (5th Cir. 1977) (citation omitted); *see also In re Kriesler*, 546 F.3d at 865-66; Henry v. Lehman Commercial Paper, Inc. (*In re* First Alliance Mortg. Co.), 471 F.3d 977, 1006 (9th Cir. 2006).

[57] *In re Mobile Steel Corp*., 563 F.2d at 700.

[58] Comm. of Unsecured Creditors of Adelphia Commc'ns Corp. v. Bank of Am. (*In re* Adelphia Commc'ns Corp.), 365 B.R. 24, 68 (Bankr. S.D.N.Y. 2007) (footnote omitted).

[59] *Id.* (citation omitted).

assisted the Rigases in siphoning value out of the Debtors through the Co-Borrowing Facilities, and 'cemented their senior creditor status when they knew that other creditors were providing capital on a junior basis without having the same information about the Rigas Family's conduct.'"[60]

Accordingly, in a Ponzi case where a claimant has engaged in inequitable or fraudulent conduct, that creditor's claim may be subordinated. That consequence would be in addition to any direct liability for fraud, aiding and abetting, or conspiracy that might be imposed against that claimant for its wrongful conduct.

D. GENERAL DISTRIBUTION SCHEME UNDER THE BANKRUPTCY CODE

After the priority and position of claims has been determined as set forth above, a trustee must then follow the priorities for distribution of property of the estate in a chapter 7 case, governed by section 726.[61] Section 726(a) deals with the general order of distribution in a chapter 7 liquidation case; section 726(b) deals with the distribution rules when there is more than one claim within a particular class; and section 726(c) deals with special distribution rules for individual debtors when the estate includes community property.

In summary, after a trustee has paid valid, non-avoided liens on property of the estate from the proceeds of the property, a trustee must distribute cash on hand in the following manner:

> (1) Section 726(a)(1): first, to timely filed claims specified in section 507 (priority claims and expenses).[62]
>
> (2) Section 726(a)(2): second, to timely filed allowed unsecured claims.
>
> (3) Section 726(a)(3): third, to tardily filed claims of claimants that had notice or knowledge of the case in time for a timely filing.[63]

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[60] *Id.* at 69.

[61] 11 U.S.C.A. § 726 (Westlaw 2012).

[62] Section 726(b) provides that, if case has been converted, then claims entitled to priority under § 507(a)(1) that are incurred in the chapter 7 case will have priority over claims entitled to priority under § 507(a)(1) that were incurred while the case was pending under a different chapter. 11 U.S.C.A. § 726(b) (Westlaw 2012).

[63] An exception exists for late filed priority claims, which will be treated as though timely filed if filed before the trustee begins distribution. *See, e.g.*, Cooper v. Internal Revenue, 167 F.3d 857 (4th Cir. 1999).

(4) Section 726(a)(4): fourth, to claims for fines, penalties and damages that do not compensate for actual pecuniary loss.

(5) Section 726(a)(5): fifth, in payment of interest at the legal rate, from the date of the filing of the petition, on any claim under sections 726(a)(1), (2), (3) or (4) above.

(6) Section 726(a)(6): sixth, in payment to debtor of any surplus.

Under these distribution rules, unless a claim has been granted priority under section 507, all other types of timely filed allowed unsecured claims, which would include both investor and non-investor claims, will be paid at the same rate under section 726(a)(2).

CONCLUSION

Given the zero sum game of allowance and payment of creditors' claims in Ponzi scheme cases, emotions run high in the final stages of administering Ponzi insolvency proceedings. Because virtually no two creditors are similarly situated, they are led to vie for priority over one another. Trustees, receivers and courts presiding over these types of proceedings strive to treat defrauded investors as equitably as possible. General unsecured creditors in a receivership case may be left out in the cold where investor claims may be given a higher priority, while the Bankruptcy Code will require a trustee to treat defrauded investors and general unsecured creditors similarly. As more of these types of cases reach the courts, creditors of bankrupt Ponzi entities will likely continue to push courts to apply equitable standards to fashion individualized relief in a given case, whereas creditors in cases pending in district courts under the administration of a receiver may find themselves challenging a proposed distribution plan that seeks to place one category of victims ahead of another.

Without any uniformity in the law or set standards for claims allowance and distribution in Ponzi cases, claimants will be forced to engage in battle after battle to assert their interests, with no clear winner of the war on the horizon. One court suggested that perhaps the treatment of claims in Ponzi cases is not a matter that should be left to the discretion of individual judges. "Many of the arguments in favor of avoidance of interest payments in a Ponzi-scheme situation rest upon seemingly arbitrary distinctions that ultimately represent policy judgments . . . that is for Congress to do, not the courts."[64]

[64] Lustig v. Weisz & Assocs., Inc. (*In re* Unified Commercial Capital), Nos. 01-MBK-6004L, 01-MBK-6005L, 2002 WL 32500567, at *5 (W.D.N.Y. June 21, 2002).