11-1516-CV(L)

11-1517, 11-1738, 11-1741, 11-1859, 11-1879

IN THE

United States Court of Appeals
FOR THE SECOND CIRCUIT

COMMODITY FUTURES TRADING COMMISSION,
SECURITIES AND EXCHANGE COMMISSION,
Plaintiffs and Appellees,

ROBB EVANS & ASSOCIATES, LLC,
Receiver and Appellee,

KERN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION,
Interested-Party, Appellee, and Cross-Appellant,
- v. -
3M EMPLOYEE WELFARE BENEFIT ASSOCIATION TRUST I, ET AL.,
Interested-Party, Appellants and Cross-Appellees,

STEPHEN WALSH, PAUL GREENWOOD, ET AL.,
Defendants.

On Appeal from the United States District Court
For the Southern District Of New York
The Honorable George B. Daniels

APPELLEE AND CROSS-APPELLANT KCERA'S PRINCIPAL & RESPONSE BRIEF

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(*Continuation of caption*)

3M EMPLOYEE WELFARE BENEFIT ASSOCIATION TRUST II, 3M EMPLOYEE WELFARE BENEFIT ASSOCIATION TRUST III, MINNESOTA MINING AND MANUFACTURING EMPLOYEE RETIREMENT INCOME PLAN TRUST, BLUE CROSS AND BLUE SHIELD ASSOCIATION NATIONAL RETIREMENT TRUST, NORTH DAKOTA STATE INVESTMENT BOARD, SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM, SAN DIEGO COUNTY EMPLOYEES RETIREMENT ASSOCIATION, KAISER ALUMINUM & CHEMICAL CORPORATION ASBESTOS PERSONAL INJURY TRUST, ALEXANDER DAWSON FOUNDATION, ALEXANDER DAWSON, INC., QWEST ASSET MANAGEMENT COMPANY, QWEST PENSION TRUST,

Interested Party - Appellants - Cross-Appellees,

STEPHEN WALSH, PAUL GREENWOOD, WESTRIDGE CAPITAL MANAGEMENT, INC.,
WG TRADING INVESTORS, L.P., WGIA, L.L.C., WESTRIDGE CAPITAL MANAGEMENT ENHANCEMENT FUNDS, INC., WG TRADING COMPANY, L.P., WGI L.L.C., K&L INVESTMENTS, JANET WALSH,

Defendants,

ACUMENT GLOBAL TECHNOLOGIES, INC., WELLS FARGO & CO. MASTER PENSION TRUST, CBS MASTER TRUST, CARNEGIE MELLON UNIVERSITY, H-E-B BRAND SAVINGS & RETIREMENT PLAN TRUST, HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM, OHIO NORTHERN UNIVERSITY, THE TIMKEN COMPANY COLLECTIVE INVESTMENT TRUST FOR RETIREMENT TRUSTS, UNIVERSITY OF PITTSBURGH - OF THE COMMONWEALTH SYSTEM
OF HIGHER EDUCATION, VULCAN MATERIALS COMPANY.

Appellees.

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JURISDICTIONAL STATEMENT

In February 2009, the Commodity Futures Trading Commission and the SEC brought federal fraud charges in federal district court, the Southern District of New York, against Stephen Walsh, Paul Greenwood, and certain investment funds they operated. (1-A-147–170; 2-A-251–272.) Federal question subject matter jurisdiction (28 U.S.C. § 1331) existed because the prosecuting agencies brought charges under federal laws, including the Commodity Exchange Act and the Securities Exchange Act of 1934. (1-A-148; 2-A-253.)

The district court appointed Robb Evans & Associates LLC as Receiver to marshal the funds' assets and oversee their distribution to various investors. (2-A-280, 305.) In January 2011, the Receiver proposed a distribution plan, to which various parties, including the Kern County Employees' Retirement Association ("KCERA"), objected. After March 16, 2011 hearing (SPA-5–154), the district court entered an order approving the Receiver's plan on March 21, 2011 (SPA-1–4). Certain parties — the WGTC Appellants — appealed that order on April 18, 2011 (6-A-1450–1457); KCERA timely cross-appealed on May 6, 2011 (6-A-1465–1468).

A basis for appellate jurisdiction — premised on reviewing interlocutory injunction orders or, alternatively, under the practical finality doctrine — appears in the WGTC Appellants' opening brief (AOB-1–2). To the extent that appellate

jurisdiction exists for the WGTC Appellants' appeal, that same basis supports jurisdiction for KCERA's cross-appeal.

The WGTC Appellants' appeal seeks reversal of the district court's decision to distribute the remaining assets of the Ponzi scheme on a *pro rata* basis. The standard of review is "abuse of discretion" — and there was no such abuse. In fact, based on the overwhelming facts and case law, it would have been an abuse of discretion to have ruled differently. The WGTC Appellants' appeal therefore fails.

KCERA's cross-appeal asks this Court to adjust the *pro rata* distribution for inflation under the well-established economic principle that a dollar in 1995 has a different value than a dollar today. Such an adjustment is a commonplace Economics 101 calculation that results in the fairest distribution.

ISSUES PRESENTED

1. **WGTC Appellant's Appeal:** Did the district court properly exercise its discretion in approving the Receiver's proposed *pro rata* distribution of assets?

2. **KCERA's Cross-Appeal:** Given that adjusting for the time-value of money is an ordinary economic principal nearly universally applied in a variety of contexts, and given that applying it here would make for a fairer distribution of

funds, did the district court's distribution order err in declining to apply a constant dollar adjustment that would account for inflation?[1]

STATEMENT OF THE CASE & FACTS

I. KCERA Loses Millions of Dollars in the Ponzi Scheme

From the mid-1990's through 2009, investment managers Stephen Walsh and Paul Greenwood engaged in a massive Ponzi scheme.[2] (*E.g.*, 2-A-328; 3-A-693; 4-A-964.) As the press widely reported, they amassed approximately $1.3 billion of investments entrusted to them by institutional investors, mostly public and private pension plans, and university foundations. (*E.g.*, 2-A-306.) They promised to invest this money using an "enhanced equity index management" process. Instead, they misappropriated over half a billion dollars to hide trading losses and to pay personal expenses — such as antique furniture, rare books, horse farms, and millions of dollars worth of collectable teddy bears. (1-A-

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[1] For an explanation of why adjusting for inflation (i.e., accounting for the time-value of money) is called a "constant dollar" approach, see the expert declaration at 5-A-1082–1083.

[2] Greenwood pleaded guilty to numerous federal charges including commodities fraud, securities fraud, wire fraud, and money laundering. (4-A-941–71; 4-A-959, 970.) *See Cunningham v. Brown*, 265 U.S. 1, 7–9 (1924) (describing the scheme of Charles Ponzi, in which earlier investors' returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity); *see also Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1088 n.3 (2d Cir. 1995) (describing characteristics of Ponzi schemes).

147, 156, 162; 2-A-252, 257, 261, 317–18; 2-A-330; 3-A-545–48, 551–604 [teddy bear inventory], 610–11 [horse ranch], 715; 4-A-806.)

The scheme was perpetrated primarily through various entities Walsh and Greenwood owned and controlled, particularly WG Trading Company, LP ("WGTC") and WG Trading Investors, LP ("WGTI"). (E.g., 1-A-147–48.) These entities had common management: Walsh and Greenberg were the majority owners of WGTC and were the general partners of WGTI. (SPA-14.) As ultimately revealed, Walsh and Greenwood acted in "utter disregard for corporate governance, and employ[ed] fraudulent accounting practices," including a "long history" of commingling WGTC and WGTI funds. (E.g., 3-A-693; 4-A-321; 5-A-1116 [WGTC and WGTI accounts treated "as if they were interchangeable"], 1122–23.) WGTI was also a limited partner of WGTC, and substantial WGTC losses, rather than being shared by all of the WGTC limited partners, were improperly passed on to WGTI alone. (SPA-14–16.)

KCERA, one of the victims of this ponzi scheme, lost millions of dollars. (SPA-97.)[3] KCERA invested in the scheme for well over a decade, whereas many

[3] KCERA is a defined benefit plan administered under California's County Employees' Retirement Law of 1937 (Cal. Gov't Code § 31450 et seq.), which provides retirement, disability, survivor and death benefits, to eligible county employees and beneficiaries in Kern County, a county approximately the size of New Jersey, in the southern central valley of California. (See www.kcera.org.)

other investors participated for as little as one or two years. (2-A-200–01, 387–96, 398; 5-A-1030–56.)

II. Federal Agencies File Charges and the Court Appoints a Receiver, Who Solicits Distribution Proposals

In February 2009, the CFTC and the SEC filed complaints against Walsh, Greenwood, and their various entities. (1-A-147–70; 2-A-251–72.) The court appointed Robb Evans & Associates as the Receiver having authority to locate, gather, and distribute collected assets. (2-A-280.)

The Receiver notified all investors, creditors and other interested parties — including KCERA — that it would start a claims administration process and afforded them an opportunity to provide proposed distribution plans. (3-A-650; 4-A-820.)

KCERA submitted a proposed distribution plan explaining why the most fair and reasonable outcome would be to distribute the assets on a *pro rata* basis, based on the net investment of each claimant calculated on a “constant dollars” basis (i.e., adjusting for inflation). (4-A-834–63.) Using constant dollars efficiently takes into account the economic reality that a dollar invested when the investment scheme began is worth substantially more than a dollar invested over a decade later, when the scheme was exposed. (4-A-839.) Without this inflationary

adjustment, short-term investors are favored at the expense of long-term investors when there is absolutely no need or justification for such a disparity.[4] (*Id.*)

The WGTC Appellants proposed an alternative distribution scheme that would massively favor their interests by treating investors in WGTC more favorably than investors in WGTI. (3-A-620–30.) As repeated in the WGTC Appellants' opening brief, this argument for favoring WGTC investors over WGTI investors rests on the misplaced notion that WGTC was "a highly-regulated entity," and was thus a "safer" investment vehicle, so that investors in the more "prudent" vehicle should benefit from an undefined "prudence premium." (3-A-624.) As detailed below, neither the Receiver nor the court ultimately adopted this novel "prudence premium" approach.

The SEC and CFTC — focusing on the best interests of the public and the defrauded investors — rejected the WGTC Appellants' approach, and instead urged a net investment *pro rata* distribution. (5-A-1109.) The agencies further acknowledged that a constant dollar approach "may be appropriate in certain instances." (5-A-1128.) Yet, without any detailed analysis, they concluded that such an inflation adjustment was not warranted given "the facts of this matter" —

[4] Another victim, QWEST, also proposed this same distribution method (5-A-1057–79), which it supported with an expert declaration demonstrating that ordinary analysis in the fields of finance, economics, public policy and law all recognize the effects of inflation. (5-A-1081–93.)

though they suggested it might apply for certain possible "future distributions" of additionally recovered funds in this case. (5-A-1128.)

III. The Receiver Proposes a *Pro Rata* Distribution But Without Adjusting for Inflation

In January 2011, the Receiver presented the district court with its proposal to distribute the funds it had gathered. (5-A-1171–88.) The Receiver proposed a *pro rata* net investment distribution without an adjustment for inflation. (5-A-1172, 1177.) The SEC and CFTC recommended that the court adopt the Receiver's approach. (SPA-9.) The WGTC Appellants opposed that proposal, again arguing that the WGTC investors should receive more favorable treatment (almost all of the money) than other defrauded investors. (5-A-1189–1218.)

QWEST replied to the Receiver's proposal by explaining how using a constant dollars adjustment — an "Economics 101 principle" — would result in a more equitable distribution plan. (6-A-1299, 1304.) In particular, that approach would yield a "smoother distribution" with a "tighter range"; that is, under the Receiver's approach, investor recovery would range between 7% to 88% of net principal investment, but under an inflation-adjusted approach, investor recovery would range only between 37% to 57% — a more equal grouping. (See graphs at 6-A-1302, 1323–24; 6-A-1304.)

QWEST also pointed out that in the *Madoff* Ponzi scheme litigation, the SEC had recommended that investor payments be "calculated in constant dollars by adjusting for the effects of inflation (or deflation)." (6-A-1307, 1329, 1350 [constant dollar approach is the only way to "achieve a fair and economically accurate allocation among Madoff customers who invested and withdrew funds in different historical periods"; the "constant-dollar approach is rooted in the classic economic concept of the time value of money and will result in greater fairness across different generations of Madoff investors — in effect, treating early investors and later investors alike in terms of the real economic value of their investments"].)

Although supporting the Receiver's *pro rata* distribution plan (6-A-1433), KCERA and QWEST objected to the Receiver's refusal to account for inflation. (6-A-1427–41.) KCERA explained that the failure to adjust for inflation would result in an inequitable distribution of the funds collected by the Receiver as it would severely punish investors who were victimized for a longer period of time. (6-A-1431, 1434–41.)

The district court heard oral argument on the Receiver's proposal on March 16, 2011. (SPA-5–154.) The Receiver outlined why it recommended a *pro rata* distribution, i.e., that case law justified this approach where there is commingling of funds and the investors are similarly situated vis-à-vis the

perpetrators. (SPA-11–13.) The Receiver also explained that the WGTC investors "should be treated the same" as WGTI investors, because both entities were controlled by the same wrongdoers and funds were transferred between them, with WGTI suffering large losses because of these transfers. (SPA-13–17.) In short, the Receiver concluded that there was a "unitary Ponzi scheme." (SPA-17.)

Finally, the Receiver argued against the constant dollar approach — i.e., adjusting for inflation — by conceding that the position was "compelling," but ultimately arguing that this would affect less than 4% of the claims and that one proponent of this approach would end up with substantially more than it otherwise would under a straight *pro rata* distribution. (SPA-22.)

Although conceding that the court had "broad discretion" (SPA-49), the WGTC Appellants argued that the court should distinguish between the WGTC and WGTI investors — and thus argued for its so-called "prudence premium" — because WGTC was the "safer" investment. (SPA-37–73.) The court was not persuaded, explaining that a *pro rata* distribution would spread investor losses more equitably. (SPA-62-63.)

QWEST urged the court not to disregard the "Economics 101" principle of accounting for inflation. (SPA-74.) And KCERA reiterated how using constant dollars to account for inflation was an essential adjustment to reach the Receiver's stated goal of treating short-term and long-term investors equally. (SPA-97–102.)

KCERA also highlighted the inappropriateness of tracing — i.e., allowing certain victims to recover specific funds in the perpetrators' possession rather than distributing the pooled funds *pro rata* — which certain investors proposed as a distribution method. (SPA-99.)

The district court, the Honorable George Daniels, made clear that he had "read the papers" and "underst[ood] what the positions are." (SPA-35; see also SPA-9, 47.) At the end of the hearing, the court found that there had been "sufficient and significant" "commingling of funds" and that the investors were "similarly situated" with regard to the fraud, their losses, and the perpetrators, such that a "net pro rata distribution is equitable," "fair and reasonable." (SPA-134–35.) In rejecting the "prudence premium" argument, the court pointed out that "from the fraudster's point of view, no distinction was made in terms of who would be the victims, [or] where the money would come from" — they simply took the money from where it was "most easily reached and the activity … most easily hidden." (SAP-135.)

Regarding constant dollar adjustment, the court noted that it might be "an alternative, equitable way" to distribute the funds, but found that "significant issues" existed regarding whether "collateral effects" of that approach made it more equitable. (SPA-135.) Ultimately, the court rejected both the prudence premium and constant dollar positions because those approaches did not make for

"a fairer distribution for either the most victims or a large number of victims." (SPA-136.)

Consequently, the district court signed the Receiver's proposed order approving the Receiver's *pro rata* distribution plan (SPA-1–4), giving rise to these appeals. On or about April 21, 2011, the Receiver distributed the approximately $793 million subject to the distribution proposal. The Receiver estimates that there will be additional funds available for further distribution.

SUMMARY OF ARGUMENT

The distribution of assets to defrauded investors is an equitable proceeding intended to achieve fairness among the victims. That goal is best reached by treating all investors equally — on a *pro rata* basis — and rejecting any artificial distinctions between types of investors. No legitimate basis exists for treating investors in WGTC more favorably for allegedly being "more prudent investors," when the perpetrators commingled funds from the supposedly "safer" and less safe investments, treating them interchangeably and exercised equal control over all investments.

The WGTC Appellant's arguments against *pro rata* distribution wholly and transparently ignore well-established law, how the various investments were intertwined and the manner in which the Ponzi scheme was operated. It is ironic that their argument rests on the supposed integrity of formal legal structures of the

investment entities when those "legal structures" were not recognized by Walsh or Greenwood and their entire operation. It is likewise ironic that the WGTC Appellants seek more favorable treatment because they were literally partners with the perpetrators of the fraud. If anything, the WGTC Appellants should be penalized, not rewarded, for their partnership with WGTC.[5]

In accord with the Receiver and the Court's ultimate goal to treat defrauded investors fairly, the district court should have adjusted for the time value of money by applying a constant dollars approach. A constant dollars approach achieves fairness between long-term and short-term investors by adjusting the amount of the claims to account for the economic reality that a dollar invested at the start of the fraud is worth substantially more than a dollar invested over a decade later. Failing to adjust for inflation treats similarly situated investors differently and thus subverts the goal of achieving the fairest outcome. In short, paying KCERA the same *pro rata* amount as short-term investors is the same as paying KCERA materially less for no good reason. This Court's intervention is needed because a distribution plan that ignores constant dollars is clearly inferior to one that does. (*See In re Bernard L. Madoff Inv. Sec. LLC*, __ F.3d __, 2011 WL 3568936, *8 n.7 (2d Cir. Aug. 16, 2011) [despite recognizing the latitude necessary in unraveling

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[5] As KCERA pointed out below, the Court could reasonably have preferred claimants such as KCERA who loaned money to the perpetrators over the WGTC Appellants who have equity interests in the perpetrator's entities. [4A-858-860.]

Ponzi schemes, discretion is abused if the method chosen is clearly inferior to other proposed methods].)

ARGUMENT RESPONDING TO THE WGTC APPELLANTS' APPEAL

I. Standard of Review

In evaluating and ultimately adopting a distribution plan, the district court was acting "pursuant to its inherent equitable powers," and thus had very "broad discretionary power" to fashion any remedy the court reasonably believed was best suited to the needs of the particular case. *SEC v. Forex Asset Mgmt.*, 242 F.3d 325, 332 (5th Cir. 2001) (affirming *pro rata* distribution, noting "wide equitable discretion" to "determine the most equitable remedy"). In short, the court had the power to adopt any plan that is "fair and reasonable." *E.g., Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 84 (2d Cir. 2006); *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 87 (2d Cir. 2002) (district court's choice of distribution plan reviewed for abuse of discretion). This Court will not disturb such a ruling absent an abuse of discretion. *E.g., SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997); *SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991); Gradwohl & Corbett, *Equity Receiverships for Ponzi Schemes*, 34 Seton Hall Legis. J. 181, 211 (2010) ("district courts have wide discretion to fashion distribution plans" in equity receiverships).

II. The District Court Correctly Held That the Funds Gathered by the Receiver Should be Distributed *Pro Rata* Because the Funds Were Commingled and the Investors Were Similarly Situated

This Court has "explicitly held that 'the use of pro rata distribution has been deemed especially appropriate for fraud victims of a Ponzi scheme ….'" *SEC v. Byers*, 637 F. Supp. 2d 166, 177 (S.D.N.Y. 2009) (quoting *Credit Bancorp*, 290 F.3d at 89 [district court has equitable authority to "treat all fraud victims alike (in proportion to their investments) and order a *pro rata* distribution"]; and citing *SEC v. Infinity Group Co.*, 226 F. App'x 217, 218 (3d Cir. 2007)); *SEC v. Malek*, 397 F. App'x 711, 715–16 (2d Cir. 2010).

Pro rata distribution plans are "the most fair and most favored in receivership cases" (*Byers*, 637 F. Supp. 2d at 176) and are particularly appropriate in Ponzi scheme cases where investor funds are commingled and victims are similarly situated as to the perpetrators (*Credit Bancorp*, 290 F.3d at 89). *See Quilling v. Trade Partners, Inc.*, 572 F.3d 293, 301 (6th Cir. 2009) (following *Credit Bancorp*); *In re The Reserve Fund Sec. & Derivative Litig*, 673 F. Supp. 2d 182, 195–196 (S.D.N.Y. 2009) (noting other circuits follow this Court's view that *pro rata* distribution is favored where investor funds are commingled and investors are similarly situated). Indeed, the principal that funds should be distributed *pro rata* comes from United States Supreme Court's decision in the original Ponzi scheme case. *See Cunningham*, 265 U.S. at 13 (ordering *pro rata* distribution

resulting from Charles Ponzi's fraud); *see also In re Dreier LLP*, 429 B.R. 112, 137 (Bankr. S.D.N.Y. 2010) (following *Credit Bancorp*).

A *pro rata* distribution acknowledges that Walsh and Greenwood failed to observe corporate formalities and customary legal distinctions among the various investment entities commingling assets. As the Receiver repeatedly concluded, "WGTC and WGTI were not operated as two stand-alone, self-sustaining businesses." (E.g., 3-A-699–701, 703, 705–706, 708, 710–711 [WGTC and WGTI "operated as a single entity" having "elements of a classic Ponzi scheme"].) This deliberate avoidance of corporate form erased any traditional legal boundaries among the entities, making them effectively *alter egos* of one another. *See CFTC v. Topworth Int'l Ltd.*, 205 F.3d 1107, 1110, 1116 (9th Cir. 1999) (*alter egos*); *SEC v. Elliott*, 953 F.2d 1560, 1565 (11th Cir. 1992) (treating various entities as one based on commingled funds and failure to maintain strict separation); *SEC v. AmeriFirst Funding, Inc.*, 2008 WL 919546, *4 (N.D. Tex. 2008) (rejecting the argument that separateness of corporate entities precludes pooling of assets for *pro rata* distribution).

The WGTC Appellants acknowledge this law, but attempt to subvert it here by attacking the district court's appropriate exercise of discretion. All of the WGTC Appellants' arguments are variations on the same theme: The differences between investing in WGTC versus WGTI require that investors in each entity be

treated differently so that the WGTC Appellants may get the lion's share of the money. The WGTC Appellants forcefully pressed this point to the district court. The district court understood the argument and in exercising its discretion, rejected it. That rejection — grounded on the decision that arbitrarily treating the investors differently because they entered the Ponzi scheme differently would not result in a fair distribution — was sound and should be affirmed.

The WGTC Appellant's arguments to the contrary fail to withstand scrutiny and cannot surmount the governing discretionary standard of review. Moreover, the court reasonably rejected the WGTC Appellant's proposed distribution plan because it was grossly inequitable: under that plan those appellants would recover almost 100% of their investments, leaving all remaining investors almost nothing. Such a result is neither fair nor reasonable.

A. The WGTC Appellants' Position on *Ex Ante* Expectations Boils Down to a Tracing Argument That Court's Universally Reject

The centerpiece of the WGTC Appellants' various arguments is that the perpetrators stole primarily from WGTI rather than the supposedly "safer" — "regulated, audited entity" — WGTC. (AOB-21.) At bottom, this is a tracing argument — i.e., an attempt to segregate whose money was really stolen — of the sort that courts routinely reject in a Ponzi scheme context involving commingled funds. *E.g., Credit Bancorp*, 290 F.3d at 89; *Byers*, 637 F. Supp. 2d at 177; *In re Dreier*, 429 B.R. at 137; *Quilling v. Trade Partners Inc.*, 2008 WL 4366039, *3

(W.D. Mich. 2008) ("tracing principles have been soundly rejected as a basis upon which to accord greater compensation to one class of victim over another"). Whatever the supposed benefits of investing in WGTC, they were not sufficient to prevent either the commingling of funds or the use of WGTC as an instrumentality of fraud.

As this Court made clear in *Credit Bancorp*, even when particular recovered assets can be traced back to particular investors, using those funds to pay those investors (to the detriment of other victims) is unwarranted because the availability of those funds derives from the "merely fortuitous fact that the defrauders spent the money of the other victims first." *Id.* at 89; *see also United States v. 13328 & 13324 State Highway 75 N.,* 89 F.3d 551, 553 (9th Cir. 1996) (upholding *pro rata* distribution and rejecting any "tracing fiction" between innocent parties); *United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996) (court exercising discretionary equitable powers need not apply tracing); Hanoch Dagan, The Law & Ethics of Restitution 302 (Cambridge Univ. Press 2004) (in Ponzi schemes "all the victims of the same fraud are treated as a class and share pro rata in all the assets" — even "assets that any one of them can identify as (or trace to) his or her property").

The WGTC Appellants acknowledge that a tracing argument fails — and that buying into the "phantom world" created by the perpetrators is absurd. (AOB-30.) They even argue (correctly) that the perpetrators' actions should not dictate

the distribution method. (*Id.*) Yet, these points cut directly *against* their position: The basis of these arguments is that to fairly compensate victims, courts will not credit how the perpetrators happened to operate when doing so means that some victims serendipitously come out ahead of others.

Here, following the WGTC Appellants' arguments would mean giving credence to formal corporate structures that were simply mechanisms of the fraud and therefore have no validity. *In re Madoff*, 2011 WL 3568936, *11 (whim of the defrauder should not control the process supposed to unwind the fraud). In contrast, as recognized by the district court, *not* crediting the perpetrators' operations means treating investors in WGTC and WGTI the same, which is a fairer distribution. This furthers the goal of "unwinding" rather than "legitimizing" the scheme. *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010).

The key fact underlying the district court's correct analysis of treating all investors the same is that it is undisputed that the perpetrators commingled WGTC and WGTI funds. The WGTC Appellants seek to downplay this crucial fact in arguing that the WGTC funds were somehow "safer" than the WGTI funds. They, of course, were not safer because all of the funds were commingled, regardless of the investment vehicle, and controlled by Walsh and Greenwood. The WGTC Appellants also argue that WGTC was "well capitalized" throughout its

operation. But it was only well capitalized because Walsh and Greenwood were improperly shifting all of the losses to WGTI. The WGTC Appellants' argument is thus based upon a fictionalized account of the facts it picks and chooses from the Receiver's findings.

Even if the WGTC Appellants' argument had merit, the district court acted well within its discretion to favor other concerns (particularly the commingling of the funds and fairness). *See* Gradwohl & Corbetee, *supra*, at 211 ("Equity takes a broad view of commingling and requires courts to focus on the forest rather than the trees. … Even if victims may be able to establish priority claims to assets, the court may mandate a pro rata distribution based on the equities.").

To avoid using "tracing" language directly, the WGTC Appellants challenge the district court's analysis by presenting their legalistic arguments as an attack on how the court purportedly analyzed the victim's "similarity" from the perpetrators' point of view, rather than focusing on differences among the investors. But the court's perspective — viewing the victims on one side and the perpetrators on the other rather than focusing on dissimilarities between the investors — was exactly right, especially in light of the commingling of funds. The WGTC Appellants cited no authority for an approach favoring one group of investors to the virtual exclusion of others or, for that matter, simply awarding more money to some investors based on illusory distinctions that are part and parcel of the fraud.

Another version of the WGTC Appellants' argument is that the district court failed to consider the investors' *ex ante* expectations — i.e., again focusing on self-perceived differences among the investors, rather than the similarities of all investors' relationships with the perpetrators and their scheme. As the WGTC Appellants portray it, the district court's reasoning was "circular" because all the investors are "by definition" similarly situated as victims, and that such an approach robs being "similarly situated" from having any meaning. This rhetoric misses key points: what makes the investors here "similarly situated" is that their funds were commingled, the entities themselves were not respected and the perpetrators controlled the operation. Nor does the court's analysis "confuse" the "similarly situated" factor with commingling. The legal standard for being similarly situated is not that the victims' circumstances are "identical," but merely that there is a "reasonably close resemblance of facts and circumstances." *Byers*, 637 F. Supp. 2d at 180 (citing *Lizardo v. Denny's Inc.*, 270 F.3d 94, 101 (2d Cir. 2001)). As the Receiver's Reports set forth in detail, such resemblance plainly exists here.

The WGTC Appellants also contend that the district court did not understand their arguments. Not so. The court carefully reviewed the papers and demonstrated a full appreciation and articulation of their arguments — but ultimately was not persuaded by them. (E.g., SPA-9, 35, 47 [Court: "You are

standing here arguing … that … you should get more money back than people who suffered a loss on unregulated, riskier investment choices.”], 51.) No authority establishes that the district court’s analysis was in any way legally deficient. The WGTC Appellants’ arguments are factually wrong — there is a “reasonably close resemblance of facts and circumstances” and their plan would lead to an unfair distribution. As a result, the district court correctly rejected them.

B. The WGTC Appellants’ Public Policy Argument is Nonsensical

The WGTC Appellants next argue that the district court focused too much on maximizing overall return to the most investors, without considering other important public policy concerns. (AOB-24.) In particular, as they see it, treating the WGTC and WGTI investors the same would foster the “moral hazard” of not favoring more prudent investing. (AOB-24.) The Court’s decision purportedly sends a bad message encouraging reckless investing — i.e., investors may make riskier investments in the hope that their losses may be reduced by the accounts of more prudent investors.

This argument collapses from the weight of its own absurdity: No investor would make the mental calculation that it might be a good idea to invest in the riskier elements of a potential Ponzi scheme because other investors will opt for “safer” investments in the same scheme, and if the scheme falls apart then money can be recovered from the accounts of those more “prudent” investors. As such,

awarding an undefined and arbitrary prudence premium simply makes no sense.[6]

The WGTC Appellants next fault the district court in arguing that it rejected all consideration of "policies favoring financial regulation and auditing" in exercising its equitable discretion (AOB-42). This argument is misplaced as the court did not abuse its discretion by focusing on maximizing an equitable return for the most investors (AOB-44). And the court never voiced the view that public policy (or moral hazard) was "irrelevant" — the court simply chose not to agree with the WGTC Appellants that this point merited a change in the distribution plan.

No rule requires the court to expressly address all points made by a party; nor to make explicit how it balances various factors when making a discretionary decision. That is, in a very real sense, the essence of such an exercise of discretion. There was no legal error, merely a discretionary choice. The ultimate

[6] Footnote 6 of the WGTC Appellants' opening brief exemplifies just how arbitrary their proposal treats the various investors. In that footnote, the WGTC Appellants argue that because one investor, IPERS, utilized a "hybrid structure that was not comparable to either the direct WGTC limited partnership or the indirect WGTI promissory note," to invest in the Ponzi scheme, "the outcome of this appeal will not affect distribution to IPERS." This statement is followed by no authority and arbitrarily rewards IPERS for investing in what the WGTC Appellants unilaterally deem a "hybrid structure." It is obvious though that the WGTC Appellants took this route because they do not want to disrupt IPERS' *pro rata* distribution thereby ensuring that the largest investor in the Ponzi scheme would oppose their proposal. In any event, treating IPERS differently than other victims that invested in WGTI through a promissory note is arbitrary and inequitable and should be rejected.

goal, of course, is for the court to distribute what funds it can in the matter it deems most fair. *See* Gradwohl & Corbetee, *supra*, at 211 ("Public policy supports the equality of distribution of the remaining assets in a Ponzi scheme."). And it is black letter law that a *pro rata* distribution accomplishes that goal.

C. The District Court Made No Factual Error in Exercising its Discretion

In yet another variation on their same theme — and another attempt to avoid the governing abuse of discretion standard — the WGTC Appellants argue that the district court made a clearly erroneous factual finding in concluding that the investors were all defrauded in the same manner. (AOB-22, 53–59.) But this argument rests on the notion that the investors were defrauded differently because the perpetrators purposely misappropriated funds primarily from WGTI rather than WGTC. In other words, because the perpetrators focused their misappropriation on WGTI, the district court supposedly made a "factual" mistake in finding that the perpetrators did not distinguish who their victims would be, or from which investment vehicle they would misappropriate funds. (AOB-53–54.)

This argument is just a replay of the WGTC Appellants' primary bone of contention, this time with a purported "factual" spin. The district court understood how the perpetrators used WGTC and WGTI to misappropriate funds: The Receiver made clear in detailed reports how the various funds were commingled and misappropriated. But focusing, as the WGTC Appellants do, on the

differences between WGTC and WGTI simply devolves into a tracing argument yet again. The district court drew no erroneous factual conclusion, but rather recognized that the factual distinction the WGTC Appellants wished to emphasize made no difference in the court's exercise of discretion.

The district court properly did not place significance on precisely how Walsh and Greenwood engaged in their looting (via WGTI as opposed to WGTC) or on the fact that funds ended up in WGTC accounts when the music stopped. Instead, the court correctly decided that it would not be swayed by the mere fortuity of how the perpetrators operated, and rather would focus on establishing a fair distribution. The WGTC Appellants provide no basis to disturb that decision.

Indeed, had the court adopted the WGTC Appellants' arguments, that would have been an abuse of discretion. Under that view, the court arguably would have — under one of the WGTC Appellants' arguments — had to essentially come up with an admittedly "*random*" value for the so-called "prudence premium." (SPA-64.) Alternatively, under another of their arguments, the value would have been $75 million (SPA-18, 64) — a significant percentage of the total disbursement benefitting only a small set of claimants. These negative, arbitrary and inequitable consequences explain why the Receiver, SEC, and CFTC opposed that approach and further bolster the reasons for this Court to reject it too.

KCERA'S CROSS-APPEAL ARGUMENT

I. The *Pro Rata* Distribution Should Be Adjusted for Inflation Using a Constant Dollars Approach

Ponzi schemes usually collapse quickly.[7] (6-A-1350.) As a result, large disparities between the duration of claimants' investments usually do not exist and do not have a significant impact on the fairness of a distribution plan. Thus, equity does not demand inflationary adjustments for insignificant time periods.

Here, the scheme lasted over a decade, meaning that failing to adjust for inflation results in the loss of millions of dollars to long-term investors like KCERA. This was the basis for the SEC repeatedly urging an inflation adjustment in the *Madoff* litigation, and applies equally here.[8] (4-A-1002, 1015; 6-A-1329,

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[7] *E.g., SEC v. Dalton*, No. 10-cv-2794 (D. Colo., filed Nov. 16, 2010) (three-year scheme); *SEC v. Anderson*, No. 10-cv-6420 (N.D. Ill., filed Oct. 7, 2010) (same); *SEC v. Brown*, No. 10-cv-5564 (S.D.N.Y., filed July 22, 2010) (two-year scheme); *SEC v. Trade-LLC*, No. 10-cv-80737 (S.D. Fla., filed June 22, 2010) (same).

[8] SEC Deputy Solicitor Michael Conley explained this rationale in detail to the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the U.S. House of Representatives. (5-A-1020–28.) As he put it: "While the final account statement approach favors earlier customers at the expense of later customers, *the SEC is also sensitive to the corresponding fairness concerns under the cash-in/cash-out method. That method of calculating net equity favors later customers at the expense of earlier customers by treating a dollar invested in 1987 as having the same value as a dollar invested in 2007.* To illustrate this concern, assume that one claimant invested $100 in the Madoff firm in 1987, a second claimant invested $100 in 2007, and neither withdrew any funds from their accounts. Under the cash-in/cash-out approach advocated by SIPC and the Trustee, the net equity of both claimants would be $100. But because, in basic economic terms, $100 in 1987 dollars is worth $183 in 2007 dollars [citation], the claimant who invested $100 in Madoff's firm 21 years before the firm collapsed

1337, 1350–51, 1364; *In re Madoff*, 2011 WL 3568936, *3 n.4; 5-A-1026 [to "achieve a fair and economically accurate allocation among Madoff customers who invested [at different times], it is appropriate to convert the dollars invested into 'time-equivalent' or constant dollars."].) *See* Sinclair & McPherson, *The Sad Tale of Multiple Overlapping Transfers: Part IV,* 29:4 Am. Bankr. Inst. J 18, 70 (May 2010) ("it would be inexcusable to adopt a supposedly equitable formula — where investors who have invested money with Madoff for years, and some for decades — and to ignore the time value of money." [t]o ignore inflation "over decades does no equity whatever").

Apart from the length of time this Ponzi scheme persisted, the circumstances here are unusual for another reason: Substantial funds were recovered for distribution. In the usual Ponzi scheme case, there is little recovery for distribution to the victims, meaning that adjustments for inflation are not meaningful to long-term investors and are very detrimental to short-term investors.[9] But here, with hundreds of millions of dollars in recovered funds to be distributed, adjusting for

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has suffered a much more substantial real-world loss than a claimant who invested $100 only one year before the collapse." (5-A-1026 (emphasis added).)

[9] *E.g., Byers*, 637 F. Supp. 2d at 169; *SEC v. Infinity Group*, 226 F. App'x at 218; *United States v. Elliott*, 62 F.3d 1304, 1307 (11th Cir. 1995) (recovery of 10.5 cents on the dollar); *United States v. Durham*, 86 F.3d 1304, 1307 (11th Cir. 1995) (distribution equal to about 10% of claims); *In re Diamond Mortg. Corp. of Ill.*, 188 B.R. 588, 590 n.1 (Bankr. N.D. Ill. 1989) ("investors will be lucky to get back 40 cents on the dollar").

inflation makes a meaningful difference to long-term investors while still permitting recent investors to recover the majority of their investment. In short, adjusting the net investment amount for inflation is the only proposed method that treats current and former investors equally.

An inflation adjustment would not be out of the ordinary. To the contrary, adjusting for the time-value of money is a commonplace Economics 101 principle followed regularly and consistently in virtually every economic, fiscal and financial context — including by our courts. (*See* 5-A-1083–1084 [expert testimony that adjusting to constant dollars has been standard economic practice for centuries and is taught in all corporate and investment finance textbooks]; 5-A-1026 [constant-dollar approach is rooted in the classic economic concept of the time value of money and will result in greater fairness across different generations of Madoff investors by "treating early investors and later investors alike in terms of the real economic value of their investments"].) As the Supreme Court has made clear, to satisfy the goal of treating "similarly situated creditors similarly" by applying sound "objective economic analysis," creditors should receive compensation for "the *time value of their money*." *Till v. SCS Credit Corp.*, 541 U.S. 465, 477 (2004) (emphasis added).

Almost a century ago, Judge Learned Hand recognized that for the law to be equitable, the law must take into account the time-value of money: "Whatever

may have been our archaic notions about interest, in modern financial communities a dollar to-day is worth more than a dollar next year, and to ignore the interval as immaterial is to contradict well-settled beliefs about value. The present use of my money is itself a thing of value, and, if I get no compensation for its loss, my remedy does not altogether right my wrong." *Procter & Gamble Distrib. Co. v. Sherman*, 2 F.2d 165, 166 (S.D.N.Y. 1924); *see also Oliveri v. Delta S.S. Lines, Inc.*, 849 F.2d 742, 746 (2d Cir. 1988) ("a dollar received in the future will almost surely have less purchasing power than a dollar has today").

Here, no one disputes that a dollar in the 1990's was worth far more than a dollar in 2009. In nearly all contexts, including Ponzi schemes, the law recognizes the "time value of money" and seeks to account for the effects of inflation when compensating victims.[10] *E.g., In re Unified Commercial Capital Inc.*, 260 B.R. 343, 351–52 (Bankr. W.D.N.Y. 2001) (recognizing in Ponzi scheme context "the

[10] *E.g., Sea Hawk Seafoods v. Exxon Corp.*, 484 F.3d 1098, 1101 (9th Cir. 2007) ("money has a time value, and prejudgment interest is there necessary in the ordinary case to compensate a plaintiff fully for a loss suffered at time t and not compensated until t + 1"); *Ramirez v. N.Y.C. Off-Track Betting Corp.*, 112 F.3d 38, 41–42 (2d Cir. 1997) (reversible error not to make explicit adjustment for time value of money in future damages award); *Oliveri*, 849 F.2d at 746; *Metz v. United Tech. Corp.*, 754 F.2d 63, 66–68 (2d Cir. 1985); *Rolf v. Blyth, Eastman Dillon & Co.*, 637 F.2d 77, 87 (2d Cir. 1970) (plaintiff "has not had the use of the principal sum in nine years since [defendant] defrauded him … a damage award without prejudgment interest … would not give [plaintiff] full compensation for the losses he suffered at the hands of his fiduciary"); *In re Livent, Inc.*, 360 F. Supp. 2d 568, 573 (S.D.N.Y. 2005); *see also Latterman v. United States*, 872 F.2d 564, 567 (3d Cir. 1989) (tax law recognizes "time value of money" principle).

universally accepted fundamental commercial principal that, when you loan an entity money for a period of time in good faith, you have given value and are entitled to a reasonable return"). In this case, with relatively few victims and long periods of time where the money was held by the perpetrators before the scheme collapsed, accounting for inflation is highly significant.

Accounting for inflation also makes for a smoother distribution with a tighter range, which is more equitable. (*See* bar graphs at 6-A-1302.) Indeed, KCERA is not the only investor that suffers an unfair loss if net investments are not adjusted for inflation. At least a dozen of the twenty-five eligible investors — the investors of more than 58% of the money invested — achieve a better outcome. (SPA-75, 81, 89–90, 92.) This refutes the district court's conclusion that such an approach does not benefit "a large number of victims." (SPA-136.) It also distinguishes KCERA's approach from the WGTC Appellants' inequitable proposal requesting nearly 100 cents on the dollar while leaving the majority of victims to collect virtually nothing, or, alternatively, the WGTC Appellants seeking some arbitrary "premium."

A constant dollar approach also does not significantly change *which* investors fare better or worse: Investors who would receive the smallest distribution under an unadjusted plan still also receive the smallest distribution applying constant dollars — the disparity is simply narrowed, because the

happenstance or fortuity of whether one invested ten years ago or ten months ago is normalized by adjusting to constant dollars.

Finally, adjusting for inflation would not be at all burdensome; inflation adjustments are commonplace applications of simple math. (SPA-80–81.) The Receiver's approach ignores the economic reality and real impact of inflation and favors late investors over early investors. And because inflation in the last few years has been low, later investors have lost significantly less purchasing power than those who invested over a decade earlier.[11]

"[I]t is not possible to do equity without consideration of the time value of the funds invested." Sinclair & McPherson, 29:4 Am. Bankr. Inst. J at 71. This Court should order that the distribution plan calculate investor claims based upon a constant dollars approach.

CONCLUSION

This Court should order a *pro rata* distribution based on the amount each investor contributed, *adjusted for inflation*. Sound law and policy supports a distribution method that accounts for inflation and thereby treats all investors equally regardless of when they invested.

[11] The Receiver's approach also inequitably favors investors lucky enough to cash out before the Government stepped in, because those investors may (depending on the success of clawback actions) get to keep tens of millions of dollars in false earnings.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on October 14, 2011 I electronically filed APPELLEE AND CROSS-APPELLANT KCERA'S PRINCIPAL & RESPONSE BRIEF with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the appellate CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system, to the following:

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I certify that this brief complies with the type-volume limitation of the Federal Rule of Appellate Procedure 32(a)(7)(B) and contains **7,159** words, exclusive of the table of contents and the table of authorities, as counted by the 2003 Microsoft Word word-processing program used to generate this brief.

I certify that this brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type style requirements of Federal Rule Appellate Procedure 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using 2003 Microsoft Word word-processing program with a 14 point Times New Roman font.

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