Ponzi Payback

Pulled assets in the nick of time? That may not be such a good thing.

By Brian J. Hunt, CPA, JD

Is a Ponzi scheme investor financially worse off if he or she withdraws some assets before the scheme is uncovered? Maybe.

Of course, when schemes are uncovered our legal system tries its best to redress the harm to investors as far as it possibly can. The question is, how are recovered funds fairly distributed?

The recent decision of *SEC v. Huber, 702 F.3d 903* (November 29, 2012) addressed this very issue. Huber operated a Ponzi scheme in which more than 100 investors lost $22.6 million. Huber told investors that he administered three investment funds using a computer-trading model. He started the funds in 1996 but, by 1998, had converted them into a Ponzi scheme to cover incurred losses. The receiver appointed to marshal and distribute the remaining assets was able to recover $7 million. Of course, some of the investors had—in an unquestionably innocent fashion—withdrawn a portion of their investment before the fraud was uncovered. The subsequent dispute concerned the treatment of those withdrawals.

The Court considered the two potential methods for allocating resources to creditors—the rising-tide method and the net-loss method—and approved the use of the former.

To illustrate how these methods function, assume the receiver distributes 20 percent of the total loss. Under the net-loss method, the recovered funds are distributed to each investor on a pro-rata basis based on the net amount lost, which means those investors who withdrew funds are better off than those who didn't. Assume Investor A invested $10,000 but withdrew $5,000 before the fraud was uncovered; Investor B invested $10,000 but made no withdrawals. Under the net-loss method, Investor A would receive $1,000 (20 percent x $5,000 = $1,000), in addition to the $5,000 withdrawn before the fraud was uncovered, for a total of $6,000. In contrast, Investor B would receive only $2,000 (20 percent x $10,000 = $2,000).

Under the rising-tide method, withdrawals are considered part of the distribution an investor receives and therefore are subtracted from the amount of the receivership assets to which the investor would have been entitled if no withdrawals had been made. Those investors who withdrew funds before the fraud was discovered may or may not be better off than those who didn't.

Specifically, Investor A, who invested $10,000 but also withdrew $5,000, would receive nothing under the rising-tide method because he or she is already deemed to have recovered $5,000 (20 percent x $10,000 = $2,000, which is less than the $5,000 previously withdrawn). In contrast, Investor B would receive $2,000 (20 percent x $10,000 = $2,000). Therefore, the rising tide lifts the unwitting investor who made no withdrawals (Investor B) to a level closer to the investor who did (Investor A).

The Court also noted that, when there are no withdrawals, the rising-tide method yields the same receivership asset distribution as the net-loss method.

Although those investors who made substantial withdrawals before the fraud was uncovered objected to being penalized, the Court noted that rather than withdrawing their own money they had withdrawn a portion of Huber's co-mingled, stolen funds. The Court observed that no investor is entitled to money stolen from other people.

Reviewing decisions from other state and federal courts, the Court concluded that the rising-tide method is the most commonly used (and judicially approved) for appointing receivership assets. Although the Court noted that the net-loss method may be more attractive when a large number of investors receive nothing, it also noted that only 18 percent of the investors in Huber's scheme received nothing under the rising-tide method.

The Court also emphasized that the choice between the net-loss and rising-tide methods only applies to innocent investors. Withdrawals made by investors who knew or should have known of the fraud can be treated as fraudulent conveyances and "clawed back" into the receivership assets.

Investors involved in a discovered Ponzi scheme must feel tremendously vulnerable and extremely betrayed. It's easy to understand that those who withdraw funds before the fraud is uncovered want even more from the receiver and will likely feel that they are entitled to the benefit of their actions. On the other hand, all the receiver and the legal system can do is strive to treat all investors as fairly and evenly as possible.

The best advice remains to choose your investments wisely. □

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