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PONZI SCHEMES AND LITIGATION RISKS: WHAT EVERY FINANCIAL SERVICES COMPANY SHOULD KNOW

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I. INTRODUCTION

As the current economic recession continues, the financial community continues to learn about many Ponzi schemes and other frauds that proliferated during recent years. Ponzi scheme investigations now make up twenty-one percent of the SEC's enforcement workload, compared with seventeen percent in 2008 and nine percent in 2005.[1] This article focuses on the litigation risks that financial institutions may encounter in the wake of a collapsed Ponzi scheme.

Part II of this article reviews the history of Ponzi schemes perpetrated in the twenty-first century.[2] Part III analyzes potential claims against financial institutions in Ponzi scheme suits, which generally include breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, as well as aiding and abetting fraud, breach of fiduciary duty, and Blue Sky violations.[3] To provide a meaningful overview from a national perspective, Part III of this article identifies and discusses state and federal laws and court decisions without attempting to reconcile any splits in authority. In Part IV, the authors survey recent trends in Ponzi scheme and investment fraud litigation against financial

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1. Curt Anderson, *Ponzi Schemes' Collapses Nearly Quadrupled in '09*, LAW.COM, Dec. 29, 2009, http://www.law.com/jsp/article.jsp?id=1202437299784.

2. *See infra* Part II, pp. 30-34.

3. *See infra* Part III, pp. 34-42.

institutions and examine these trends in the context of financial institutions that knowingly participate in or facilitate Ponzi schemes, as well as those that unwittingly conducted business with businesses that later proved to be Ponzi schemes.[4] Part IV also includes a discussion of fraudulent transfer litigation activity in the fraudulent transfer context.[5] Finally, Part V identifies proposed federal legislation that could abrogate the Supreme Court's holding in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[6] which severely restricted aiding and abetting claims in the context of Ponzi scheme liability.[7] If enacted, the legislation could reopen the door to litigation against financial institutions and others who may unwittingly participate in such a scheme.

II. HISTORY OF PONZI SCHEMES

A Ponzi scheme is generally a fraudulent investment scheme whereby an operator makes payments to early investors with money received from new investors.[8] Ponzi scheme operators promise original investors abnormally high or fast returns, often by suggesting that they use a unique strategy or investment mechanism.[9] The Ponzi scheme operators repay the original investors with later investments creating the illusion that they have fulfilled their promise of rapid success.[10] This attracts new investors.[11] Inevitably, the Ponzi scheme operator is unable to recruit new investors to fund the original investors' payment

4. *See infra* Part IV, pp. 43-53; *see also* Wayne E. Baker & Robert R. Faulkner, *Diffusion of Fraud: Intermediate Economic Crime and Investor Dynamics*, 41 CRIMINOLOGY 1173, 1174 (2003) (explaining that, while many Ponzi schemes are planned, created, and designed from inception to defraud investors, other business enterprises only become fraudulent after years of legitimate operation. Unlike the traditional "pre-planned [Ponzi] frauds," "intermediate frauds" occur when fraudulent acts are committed by or as part of a legitimate business).

5. *See infra* pp. 48-51.

6. 552 U.S. 148 (2008).

7. *See infra* Part V, pp. 53-56.

8. *In re* United Energy Corp., 944 F.2d 589, 590 n.1 (9th Cir. 1991). *See generally* Cunningham v. Brown, 265 U.S. 1, 7-8 (1924) (describing Charles Ponzi's original pyramid scheme).

9. *In re United Energy Corp.*, 944 F.2d at 590 n.1.

10. *Id.*

11. *Id.*

returns, and the Ponzi scheme collapses leaving all current investors' investments mired in the Ponzi scheme.[12]

A. *The Origin of Ponzi Schemes*

Ponzi schemes are named after an early twentieth century scam orchestrated by Charles Ponzi.[13] Between 1919 and 1921, Ponzi pretended to buy and sell international postal reply coupons in different markets and solicited thousands of Bostonians to invest in his fraudulent operation.[14] He accumulated 40,000 investors by promising fifty-percent returns in forty-five days.[15] But rather than paying the investors from actual profits, Ponzi paid them from new investors' investments.[16] Eventually the well of new investors ran dry and the scam failed, but not before Ponzi made millions of dollars.[17] Today, Charles Ponzi's legacy lives on, and the label "Ponzi" attaches to any scheme that involves a fraudster who uses money from later investors to repay earlier investors in whole or in part.

B. *Recent High Profile Ponzi Schemes*

Fraudsters have used Ponzi schemes to defraud innocent investors for decades, but in recent years, Ponzi scheme operators have orchestrated larger and more sophisticated schemes.[18] In 2008, authorities uncovered the largest Ponzi scheme in history orchestrated by Bernard L. Madoff.[19] A former chairman of the

12. *See Cunningham*, 265 U.S. at 8-9.
13. *See id.* at 7-8.
14. *Id.*
15. *Id.* at 7-9.
16. *Id.* at 8.
17. *Id.* at 9.
18. Del Quentin Wilber, *Economic Downturn Accelerates Collapse of Ponzi Schemes*, WASH. POST, Jun. 12, 2009, at B1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/11/AR20090611039 93.html ("As recently as a few decades ago, most Ponzi schemes were relatively small, relying on word of mouth, direct mail and advertisements in magazines. They generally burned out after two or three years. But through the Internet and modern communications, Ponzi schemes have grown in size, scope and sophistication.").
19. Joshua Brockman, *Q&A: Madoff Case Puts Spotlight on SEC*, NAT'L PUB. RADIO, Dec. 17, 2008, http://www.npr.org/templates/story/story.php?storyId=98272825.

NASDAQ exchange, he founded Bernard L. Madoff Investment Securities, LLC (Madoff Investments) to facilitate his Ponzi scheme.[20] Despite many years of success, the precipitous downturn in the economy and the stock market collapse caused Madoff's scheme to unravel in December 2008.[21] The authorities arrested Madoff on December 11, 2008, for operating a $65 billion Ponzi scheme since at least the 1990s and possibly for more than thirty years.[22]

Robert Allen Stanford allegedly operated another high-profile Ponzi scheme through his company, the Stanford Financial Group.[23] Stanford solicited investments totaling as much as $8 billion based on high-yield certificates of deposit issued by the Stanford Financial Group's bank in Antigua.[24] Each month, along with his former college roommate, James Davis, Stanford allegedly set a predetermined rate of return for the certificates.[25] Then, Stanford's accountants "reverse-engineered financial statements" to reflect non-existent investment income earned by the bank.[26] The SEC also alleged that Stanford and Davis "misappropriated" at least $1.6 billion worth of investors' money through "bogus personal loans" to Stanford for "speculative, unprofitable private businesses controlled by Stanford."[27] He consequently enjoyed many years of prosperity before his scheme collapsed.[28] He

20. *See* Diana B. Henriques, *New Description of Timing on Madoff's Confession*, N.Y. TIMES, Jan. 10, 2009, at B1, *available at* http://www.nytimes.com/2009/01/10/business/10madoff.html?_r=1.

21. *See* Robert Frank, *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1, *available at* http://online.wsj.com/article/SB123685693449906551.html?mod=djemalertNEWS.

22. *See id.*

23. *See* Clifford Kraus et al., *Texas Firm Accused of $8 Billion Fraud*, N.Y. TIMES, Feb. 18, 2009, at A1, *available at* http://www.nytimes.com/2009/02/18/business/18stanford.html?_r=1&ref=business.

24. Anna Driver, *U.S. Charges Stanford With Massive Ponzi Scheme*, REUTERS, Feb. 27, 2009, http://www.reuters.com/article/idUSTRE51Q66G20090228.

25. *Id.*

26. *Id.*

27. *Id.*

28. *See generally* Kraus, *supra* note 23 ("In Texas, Robert Allen Stanford was just another wealthy financier. But in the breezy money haven of Antigua, he was lord of an influential financial fief, decorated with a knighthood, courted by government officials and basking in the spotlight of sports and charity events on which he so generously showered his fortune.").

surrendered to the FBI on June 18, 2009, and was indicted that same day for operating a multi-billion dollar Ponzi scheme.[29]

While Madoff and Stanford may have perpetrated the two largest Ponzi schemes in U.S. history, they were certainly not the first to rob innocent investors. Before Madoff and Stanford, Bradford Bleidt facilitated "a slow-motion Ponzi scheme in Massachusetts that lasted 20 years."[30] Bleidt promised investors that he would manage and invest their funds, but instead, he used the funds to fuel a lavish lifestyle.[31] In the end, he cheated 125 clients out of $32.6 million.[32] Bleidt has since been sentenced to eleven years in prison.[33]

Likewise, Summit Accommodators Inc. (Summit) allegedly orchestrated a Ponzi scheme with funds that it received from investors in short-term real estate transactions for Section 1031 tax benefits.[34] Instead of investing the money in real estate, Summit's owners allegedly transferred the investment funds to its affiliate, Inland Capital Corp. (Inland Capital), which made loans, including to Summit's owners.[35] When Summit's investors demanded the return of their funds before the loan from Inland Capital had come due, Summit financed the return of the funds with new

29. Zachary A. Goldfarb & Anita Kumar, *Stanford, 5 Associates Charged with Running a $7 Billion Ponzi Scheme*, WASH. POST, June 20, 2009, at A11, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/19/AR2009061900078.html.

30. *See Investors Relive Bradford Bleidt Ponzi Case*, PatrickPretty.com, (Jan. 20, 2009, 5:17 AM), http://patrickpretty.com/2009/01/20/investors-relive-bradford-bleidt-ponzi-case/.

31. Robert Weisman, *An Earlier Ponzi Pain Lingers*, BOSTON GLOBE, at 1, Jan. 20, 2009, *available at* http://www.boston.com/business/articles/2009/01/20/an_earlier_pon zi_pain_lingers/.

32. *Id.*

33. *Id.*

34. Courtney Sherwood, *Summit Accommodators Case Draws Umpqua's Ire*, PORTLAND BUS. J., Jan. 22, 2010, *available at* http://portland.bizjournals.com/portland/stories/2010/01/25/story8.html?b=1264395600%5E2769061&s=industry&i=bankruptcies. It appears that Summit and Inland Capital were initially legitimate business operations but later turned fraudulent. *Id.*; *see also* Karina Brown, *Trustee Claims Bank Abetted Ponzi Scam,* COURTHOUSE NEWS SERVICE, Jun. 23, 2009, http://www.courthousenews.com/2009/06/23/Trustee_Caims_Bank_Abetted_Ponzi_Scam.htm ("Inevitably, the owners' embezzlement caused liquidity problems, and when the company was unable to pay its bills, the owners started a Ponzi scheme, bringing in new investors in order to pay the old ones, the receiver says.").

35. Brown, *supra* note 34.

investments it received until 2008 when it filed for bankruptcy.[36] The bankruptcy trustee claims that Summit was perpetrating a Ponzi scheme, while Summit's owners maintain that they simply lacked liquidity.[37]

These Ponzi schemes are just a few of the many that have been recently discovered in the wake of the financial downturn. Whether designed from inception to defraud investors or becoming fraudulent after a period of legitimate business operations, these Ponzi schemes left many innocent investors in financial ruin.

III. CLAIMS AGAINST FINANCIAL INSTITUTIONS

The inevitable insolvency of a Ponzi scheme operator, coupled with the almost overnight evaporation of fictitious investments, prompts bankruptcy trustees, receivers, and aggrieved investors to aggressively pursue recovery efforts against all solvent parties–however innocently and unwittingly involved in the Ponzi scheme operator's activities. Targets often include the financial institutions that unknowingly played even remote roles in Ponzi schemes. Financial institutions that invested in Ponzi schemes for their own accounts or on behalf of their investor clients, and certainly those financial institutions that knowingly facilitated the business operations of a Ponzi scheme, face the greatest litigation risks. Even those financial institutions that unwittingly participated in Ponzi schemes encounter many claims relating to their involvement. Because creative attorneys are filing suits based on an increasing number of grounds, Ponzi scheme litigation against financial institutions is increasing.[38]

Financial institutions face claims including common law claims for breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, aiding and abetting fraud,

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36. *Id.*

37. Sherwood, *supra* note 34.

38. *See* Stephanie Plancich & Svetlana Starykh, *Recent Trends in Class Action Litigation: 2009 Mid-Year Update*, NERA ECONOMIC CONSULTING (July 2009), at 11, http://www.nera.com/image/Recent_Trends_Report_0709.pdf (finding that between January 1, 2007 and June 30, 2009, Ponzi scheme filings comprised 3.5% of all federal class action filings, up from 0.2% in the previous two years).

and aiding and abetting breach of fiduciary duty.[39] In addition, aggrieved plaintiffs are increasingly bringing claims for violations of state Blue Sky laws.[40] The following list of potential claims, while not exhaustive, provides a practitioner with a primer on the strengths and limits of these claims.

A. Breach of Fiduciary Duty

To prevail on a breach of a fiduciary duty claim, a plaintiff must establish both a fiduciary relationship between the parties and a breach of the fiduciary duty.[41] Generally, a bank does not owe fiduciary duties to a customer in a deposit or lending relationship or to third parties that might be affected by that relationship.[42] Instead, the relationship between a bank and a depositor is typically a debtor-creditor relationship.[43] In an effort to overcome this obstacle, claimants often seek to prove that a fiduciary relationship existed as a result of a specific trust implied from the case-specific evidence.[44] While a plaintiff may contend that it "reposed trust and confidence" in a financial institution–for example, one that acted as the "bank of record" for an investment program–such "unilateral trust or confidence does not automatically create a fiduciary relationship; the trust or confidence must be accepted [by the financial institution] as well."[45]

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39. *See, e.g.*, Class Action Complaint ¶¶ 58-90, Inversiones Mar Octava Limitada v. Banco Santander, S.A., No. 09-20215 (S.D. Fla. filed Jan. 26, 2009) (alleging violation of securities laws, breach of fiduciary duty, gross negligence, negligent misrepresentation, unjust enrichment, and professional malpractice); Amended Complaint ¶¶ 35-84, Fine v. Sovereign Bank, No. 06-11450-NG (D. Mass. filed Dec. 7, 2006) (alleging, among other claims, aiding and abetting breach of fiduciary duty and negligence).

40. *See* Class Action Complaint & Jury Demand ¶¶ 47-57, Grossbard v. Sec. Am., Inc., No. 8:09-cv-00350-JFB-TDT (D. Neb. filed Oct. 1, 2009); Complaint ¶¶ 54-55, Purdue Ave. Investors LP v. Morgan Keegan & Co., No. DC-09-14448 (N.D. Tex filed Oct. 9, 2009).

41. *See* Musalli Factory for Gold & Jewellry v. JP Morgan Chase Bank, N.A., 261 F.R.D. 13 (S.D.N.Y. 2009) (holding that a lender is not a fiduciary of a debtor and therefore owes no fiduciary duties, not even reaching the question of whether a fiduciary duty had been breached).

42. *See id.* at 26.

43. *Id.*

44. *See id.*

45. *See id.*

The case of *Mazzaro de Abreu v. Bank of America Corp.*[46] provides insight into how a fiduciary duty might be created.[47] In considering a claim for aiding and abetting breach of fiduciary duty, the *Mazzaro* court found that the Bank of Europe created a fiduciary duty when it solicited investments "with the written promise of a profitable return."[48] The court went on to find that the Bank of Europe breached its fiduciary duties by stealing and spending the plaintiffs' money.[49]

B. Negligence

In order to prevail on a negligence claim against a financial institution, the plaintiff, in this case the defrauded investor, must prove two things. First, a plaintiff must prove that the Ponzi scheme operator's use of a financial institution created a duty between the defrauded investor and the financial institution. Second, a plaintiff must prove that the financial institution breached that duty.[50] As a threshold matter, a court must decide as a matter of law whether such a legal duty exists between the parties.[51] Courts consider the foreseeability and likelihood of injury, the social utility of the financial institution's conduct, the gravity of the burden placed on the financial institution to guard against injury, and the consequences of imposing such a burden.[52]

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46. 525 F. Supp. 2d 381 (S.D.N.Y. 2007).

47. *Id.* at 385-86. The plaintiffs sued defendants Bank of America Corporation, Bank of America, N.A., and Standard Chartered Bank for allegedly participating in and substantially assisting in a fraud and money laundering scheme perpetrated by Bank of Europe. The defendants were correspondent banks employed by Bank of Europe to "perform basic banking operations" and to "process transactions on its behalf." *Id.* at 384. The plaintiffs alleged that the defendants improperly transferred funds in numerous instances to offshore companies controlled by Bank of Europe and its owner. As alleged, the Court found no aiding and abetting liability and granted the defendants' motion to dismiss. *Id.*

48. *See id.* at 394 (citing Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 446 F. Supp. 2d 163, 195-96 (2006)).

49. *See id.*

50. *See, e.g.,* Rozsa v. May Davis Group, 187 F. Supp. 2d 123, 131 (S.D.N.Y. 2002); Trautenberg v. Paul, Weiss, Rifkind, Wharton & Garrison LLP, 629 F. Supp. 2d 259, 262 (S.D.N.Y. 2007).

51. *See, e.g.*, Calbillo v. Cavender Oldsmobile, Inc., 288 F.3d 721, 728 (5th Cir. 2002).

52. *See* Graff v. Beard, 858 S.W.2d 918, 920 (Tex. 1993); *see also* Harrison v. Dean Witter Reynolds, Inc., 715 F. Supp. 1425, 1435 (N.D. Ill. 1989), *rev'd on other*

A special relationship may create a legal duty where the financial institution is vested with a right of control over the proceeds of the investor's investment.[53] Absent finding that legal duty exists, there cannot be liability for negligence.[54]

C. *Negligent Misrepresentation*

For negligent misrepresentation, a plaintiff must generally prove that the defendant owed a duty, that the defendant made a false representation, and that the plaintiff reasonably relied on that misrepresentation.[55] Similar to the requirements for a negligence claim, a plaintiff must also prove that a special relationship giving rise to a duty to disclose existed between the investor and the financial institution. The failure to prove such a relationship will likely prove fatal to a negligent misrepresentation claim.[56] Therefore, in order to successfully defend against a negligent misrepresentation claim, a financial institution should focus on negating the existence of a legal duty. A special relationship of trust or confidence between the parties is evidence that the plaintiff reasonably relied on the false representation. Therefore, by negating the existence of such relationship that often times may give rise to a legal duty, the financial institution can successfully argue that the investor did not reasonably rely upon the financial institution's representation.

Courts generally consider three factors when determining whether an investor reasonably and justifiably relied on a financial

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grounds, 974 F.2d 873 (7th Cir. 1992) (describing the four factors used to evaluate whether there is a legal duty); Greater Houston Transp. Co. v. Phillips, 801 S.W.2d 523, 525 (Tex. 1990) ("In determining whether the defendant was under a duty, the court will consider several interrelated factors, including the risk, foreseeability, and likelihood of injury weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against the injury, and the consequences of placing the burden on the defendant.").

53. *See Graff*, 858 S.W.2d at 920 ("Under Texas law, in the absence of a relationship between the parties giving rise to the right of control, one person is under no legal duty to control the conduct of another, even if there exists the practical ability to do so.").

54. *See id.*

55. Musalli Factory for Gold & Jewellry v. J.P. Morgan Chase Bank, N.A., 261 F.R.D. 13 (S.D.N.Y. 2009) (quoting Hydro Investors, Inc. v. Trafalgar Power, Inc., 227 F.3d 8, 20 (2d Cir. 2000)).

56. *See id.*

institution's representation: "[(1)] whether the person making the representation held or appeared to hold unique or special expertise; [(2)] whether a special relationship of trust or confidence existed between the parties; and [(3)] whether the speaker was aware of the use to which the information would be put."[57]

D. Fraudulent Transfer

The Uniform Fraudulent Transfer Act (UFTA),[58] adopted in all but a handful of states, [59] is often used as a tool to recover funds paid out or distributed by a Ponzi scheme operator.[60] In the fraudulent transfer context, a Ponzi scheme operator is considered a "debtor" and each defrauded investor is a "tort creditor."[61] The fraudulent transfer may be a payment to an investor,[62] but it might also be a collateral pledge to a secured lender.[63]

Fraudulent transfer liability requires the claimant to establish the "actual intent to hinder, delay, or defraud any creditor of the debtor."[64] Establishing this in the Ponzi scheme context is relatively easy because the existence of a Ponzi scheme operated by the debtor serves as conclusive proof of "actual intent to hinder, delay, or defraud" a creditor.[65] This presumption exists because "actual intent" is defined under the UFTA to include transfers by insolvent debtors or debtors nearing insolvency.[66]

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57. *See id.*

58. Unif. Fraudulent Transfer Act §§ 1-14, 7A Pt. II ULA 13-556 (2006).

59. Nat'l Conference of Comm'r of Unif. State Laws, *A Few Facts About the Uniform Fraudulent Transfer Act*, UNIFORM LAW COMMISSIONERS (2002), http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ufta.asp. *Id.* As of June 5, 2005, forty-four states have adopted the UFTA, according to the National Conference of Commissioners on Uniform State Laws. Texas has adopted its version of the Uniform Fraudulent Transfer Act under Chapter 24 of the Tex. Bus & Comm. Code. California adopted its version under Cal. Civ. Code Section 3439, *et seq.*

60. *E.g.* Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. (Ill.) 1995).

61. *Id.* at 755

62. *Id.*

63. SEC v. Madison Real Estate Group, LLC, 647 F. Supp. 1271, 1279 (D. Utah 2009).

64. Unif. Fraudulent Transfer Act § 4(a)(1) (1984).

65. *Madison Real Estate Group, LLC*, 647 F. Supp. 2d at 1279.

66. Unif. Fraudulent Transfer Act § 4(b)(9); *see also In re* Evergreen Security, Ltd., 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003) ("When the existence of a Ponzi

Because courts have found as a matter of law that Ponzi schemes are insolvent from their inception, all transfers from a Ponzi scheme are presumptively made during insolvency.[67]

Essentially, those who invest before a Ponzi scheme's collapse are "entities to whom the [Ponzi scheme operator] became indebted when the investors entrusted their money."[68] When Ponzi scheme operators make transfers to earlier investors with the presumed[69] actual intent to defraud later investors, such transfers may qualify as fraudulent under the UFTA.[70]

E. Aiding and Abetting Liability

1. Aiding and Abetting Fraud and Breach of Fiduciary Duty

In order to recover losses based upon a claim of aiding and abetting fraud or breach of fiduciary duty, a plaintiff must prove: (1) fraud or breach of fiduciary duty by the Ponzi scheme operator, and (2) that the financial institution had actual knowledge of the violation.[71] Additionally, with regard to a claim for aiding and abetting fraud, a plaintiff must prove that the financial institution provided substantial assistance in order to further the violation.[72] Similarly, to prevail on a claim for aiding and abetting a breach of fiduciary duty, a plaintiff must prove that a financial institution knowingly participated in the breach.[73] For example, under New York law, "an entity 'knowingly participates

scheme is proven by the evidence a presumption of actual fraudulent intent is presumed.").

67. Scholes v. Lehmann, 56 F.3d 750, 755; *In re* Randy, 189 B.R. 425, 441 (N.D. Ill. 1995); *see also* Quilling v. Schonsky, 247 F. App'x 583, 586 (5th Cir. 2007) (finding that under the UFTA Ponzi schemes are insolvent by definition from the time of their inception).

68. *Madison Real Estate Group, LLC*, 647 F. Supp. 2d at 1279 (quoting Floyd v. Dunson (*In re* Rodriguez), 209 B.R. 424, 433 (Bankr. S.D. Tex. 1997)).

69. *See In re Evergreen Security*, 319 B.R. at 253.

70. *See Madison Real Estate Group, LLC*, 647 F. Supp. 2d at 1279.

71. *See* Mazzaro de Abreu v. Bank of Am. Corp., 525 F. Supp. 2d 381, 387 (S.D.N.Y. 2007); Musalli Factory for Gold & Jewellry v. JP Morgan Chase Bank, N.A., 261 F.R.D. 13, 24 (S.D.N.Y. 2009).

72. *See Mazzaro*, 525 F. Supp. 2d at 387.

73. *Id.* at 392.

in a breach of fiduciary duty only when it provides substantial assistance to the primary violator.'"[74]

Actual knowledge cannot generally be established solely through allegations about the failure to investigate or discover warning signs of Ponzi scheme fraud.[75] While inaction alone is not enough, the Second Circuit has suggested that facts which give rise to a "strong inference" that the financial institution had knowledge of the Ponzi scheme may be enough to satisfy the actual knowledge requirement.[76] This inference "may be established by either: (a) alleging facts to show that [the financial institution] had both motive and opportunity to commit fraud; or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[77] Hence, "actual knowledge may be implied from a strong inference of fraudulent intent,"[78] but a "plaintiff must allege more than [an] interest in bank fees . . . to create a reasonable inference of fraudulent intent."[79]

A failure to act does not constitute an affirmative or overt act sufficient to meet the substantial assistance requirement.[80] Furthermore, a simple allegation that a financial institution held funds from a Ponzi scheme in a customer's deposit account is insufficient, without more, to constitute an affirmative act that would subject a bank to liability.[81] Furthermore, "ignored advice is

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74. *Id.* at 393.

75. *See* Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 446 F. Supp. 2d 163, 202-03 (S.D.N.Y. 2006).

76. *See generally* Lerner v. Fleet Bank, N.A., 459 F.3d 273, 293 (2d Cir. 2006) ("The plaintiffs allege in detail that the banks knew that Schick engaged in improper conduct that would warrant discipline by the Appellate Division, but those alleged facts do not give rise to the 'strong inference' required by the Federal Rule of Civil Procedure 9(b), of actual knowledge of his outright looting of client funds.").

77. Dominic J. Campisi, *The Black Swans (and Other Cliches) Have Come Home to Roost: Trustee Liability in a Sigma Seven World*, *in* LESSONS FROM THE "SIGMA SEVEN" MELT-DOWN AND THE LITIGATION LANDSCAPE 25 (ALI-ABA 2009) (*citing* Lerner, 459 F.3d 273).

78. *Mazzaro*, 525 F. Supp. 2d at 388-89 (finding that a bank's alleged profit motive is insufficient to infer the fraudulent intent necessary to support a finding of actual knowledge).

79. *Id.* (citing Renner v. Chase Manhattan Bank, No. 98 Civ. 926 (CSH), 2000 U.S. Dist. LEXIS 8552, 2000 WL 781081 at 13 (S.D.N.Y. June 16, 2000)).

80. *See* Ontario Ltd. v. Zurich Capital Markets, Inc., 249 F. Supp. 2d 974, 990 (N.D. Ill. 2003).

81. *See id.*

not substantial assistance in the achievement of an underlying fraud."[82]

At least one case suggests that actual knowledge coupled with continued participation is not always sufficient to establish liability.[83] In *Mazzaro,* the court declined to impose liability on Bank of America for aiding and abetting fraud.[84] In that case, the court concluded that the bank had actual knowledge because it advised the Ponzi scheme operator how to conceal its fraudulent activities more effectively.[85] The court determined, however, that because the Ponzi scheme operator did not take this advice, the conduct did not amount to substantial assistance, and therefore liability for such advice under an aiding and abetting fraud theory was improper.[86] *Mazzaro* reinforces the idea that proof of actual knowledge and fraudulent conduct is not enough to prevail under an aiding and abetting fraud theory. Therefore, plaintiffs also must prove that the actual knowledge and fraudulent conduct amounted to substantial assistance.

2. Aiding and Abetting Fraud Under Blue Sky Laws

Plaintiffs are increasingly seeking relief under state Blue Sky laws,[87] many of which contain the same elements of and defenses to aiding and abetting liability as do state common law claims.[88] With the exception of New York, most states, including

82. *Mazzaro*, 525 F. Supp. 2d at 392 (holding that because the bank's suggestion to the Ponzi scheme operator to "open a separate bank account to 'conceal the fraud more effectively'" was ignored, such conduct did not rise to substantial assistance in the achievement of the underlying fraud).

83. *Id.*

84. *Id.* at 398.

85. *Id.* at 390-92, 394. This case came before the court on a motion to dismiss. *Id.* at 383 n.4. Pursuant to FED. R. CIV. P. 12, the court took all factual allegations in the plaintiffs' petition as true. *Id.* The authors make no presumption that the facts in the plaintiffs' complaint are true.

86. *Id.* at 392.

87. Richard I. Alvarez & Mark J. Astarita, *Introduction to the Blue Sky Laws*, SECLAW.COM, ("While the SEC directly, and through its oversight of the NASD and the various Exchanges, is the main enforcer of the nation's securities laws, each individual state has its own securities laws and rules. These state rules are known as 'Blue Sky Laws.'").

88. *E.g.,* TEX REV. CIV. STAT. ANN. art. 581, § 33 (Vernon Supp. 2010); CAL. CORP. CODE § 25504 (West 2010).

Texas and California, allow a private plaintiff to sue a financial institution that materially aided the fraudulent sale of securities issued and sold in connection with a Ponzi scheme.[89] Further, the common defenses to aiding and abetting liability under state common law and Blue Sky laws include the financial institution's lack of knowledge or awareness and the lack of privity between the investor and the financial institution.[90]

In *Sterling Trust Co. v. Adderley*,[91] investors sued Sterling Trust Co., the custodian of Ponzi scheme funds, for aiding and abetting fraud under the Texas Securities Act (TSA). The TSA, like other states' Blue Sky laws, provides for secondary liability for both intentional and reckless conduct.[92] Namely, one "who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security" may be liable.[93]

In *Sterling*, the Texas Supreme Court placed limits on the reckless-conduct standard. Specifically, the court held that an aiding party is subject to secondary liability "only if it rendered assistance to the seller in the face of a perceived risk that its assistance would facilitate untruthful or illegal activity by the primary violator."[94] Although the aiding party need not know of the exact misrepresentation or omission made by the seller, the court held an aiding party "must be subjectively aware of the primary violator's improper activity."[95] This requirement is similar to the actual knowledge required to impose secondary liability under common law.

89. *Compare* TEX. REV. CIV. STAT. ANN. art. 581, § 33 (Vernon Supp. 2010), *and* CAL. CORP. CODE § 25504, *with* N.Y. GEN. BUS. § 352 (McKinney 2010). The New York statute does not provide for a private right of action. Therefore, only the Attorney General, not individual plaintiffs, can sue for fraudulent sales of securities. Individual plaintiffs must pursue common law claims.

90. *E.g.* TEX. REV. CIV. STAT. ANN. art. 581, § 33F; CAL. CORP. CODE § 25504; N.Y. GEN. BUS. 352.

91. 168 S.W.3d 835 (Tex. 2005).

92. *Sterling Trust Co.* 168 S.W. 2d at 839.

93. *Id.* (quoting TEX. REV. CIV. STAT. ANN. art. 581, § 33F(1)-(2)).

94. *Id.* at 842 (internal quotation marks omitted).

95. *Id.* at 837.

IV. RECENT LITIGATION TRENDS

In recent Ponzi scheme litigation, plaintiffs have most frequently filed suit based on the defendant financial institutions' knowing participation in the schemes or, conversely, the financial institutions' indirect and unwitting participation in the frauds. Claims against financial institutions for fee disgorgement and unjust enrichment have also been brought under the UFTA.

A. Allegations of Knowing Participation in a Ponzi Scheme

Plaintiffs have filed numerous civil complaints against financial institutions that allegedly knowingly played roles in Ponzi schemes. While many of the claims and allegations may be considered specious at best, certain common underpinnings exist. Most claims against these financial institutions are couched as either securities law violations or common law claims, such as breach of fiduciary duty, negligence, aiding and abetting fraud, or aiding and abetting breach of fiduciary duty. Often, the financial institution's liability hinges on whether the plaintiff can prove the institution's actual knowledge of the underlying Ponzi scheme.

1. *MLSMK Investments Co. v. JP Morgan Chase & Co.*[96]

MLSMK Investments Co. (MLSMK) sued JP Morgan Chase & Co. and JP Morgan Chase Bank, N.A. (together, Chase) for "knowingly [participating] in Madoff's continuing scheme to defraud investors."[97] The complaint alleges claims for racketeering under 18 U.S.C. § 1962(d), aiding and abetting breach of fiduciary duty, commercial bad faith, and two counts of negligence.[98]

According to the complaint, Madoff directed all money received in his investment advisory business to Chase.[99] The alleged wrongful activity began in 2006, when Chase developed a derivative product specifically for use with Madoff-related

96. Complaint, No. 1:09-cv-04049-swk (S.D.N.Y. filed Apr. 23, 2009).

97. *See id.* ¶ 42.

98. *See id.* ¶¶ 48-133.

99. *See generally id.* ¶¶ 24-27 (explaining how Madoff's business relationship with Chase resulted in billions of dollars in working capital for Chase).

investments.[100] Ultimately, Chase's mid-2008 investment into a Madoff fund prompted a due diligence investigation, which raised concerns regarding Madoff's reported gains during a period of substantial market losses.[101] The plaintiffs alleged that, during the course of this due diligence investigation, Chase learned that Madoff's returns were implausible and quietly began liquidating its holdings in Madoff's funds.[102] Despite this alleged actual knowledge of the fraud, Chase "knowingly [participated] in Madoff's continuing scheme to defraud investors" when it continued to provide Madoff with banking services and to trade with him, allegedly creating "the volume of trading necessary to create the illusion that [Madoff Investments] was generating a trading volume consistent with having $7.2 billion under management."[103] This alleged ongoing cooperation by Chase allowed Madoff and Madoff Investments to continue operations through the end of 2008.[104] MLSMK invested $12.8 million with Madoff Investments during the fall of 2008.[105]

MLSMK's racketeering claim is based on the trades and ongoing banking operations Chase provided to Madoff from September 2008 to December 2008.[106] MLSMK alleges that, given this knowledge, Chase "knowingly and purposefully conspired to violate 18 U.S.C. § 1962(c) by providing Madoff with banking services that were integral to the functioning of the racketeering enterprise."[107] This assistance also forms the basis of MLSMK's aiding and abetting breach of fiduciary duty claim.[108]

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100. *See generally id.* ¶ 33 (explaining how the derivative product was linked to the performance of the funds that an asset management group in Connecticut owned and managed).

101. *See generally id.* ¶¶ 33-42 (detailing the extensive due diligence that Chase carried out on Madoff's portfolio strategy, and how Chase realized that Madoff's reported returns were false and illegitimate).

102. *See* Complaint ¶¶ 40-41, *MLSMK Inv. Co.*

103. *Id.* ¶ 42.

104. *See id.* ¶ 43.

105. *Id.*

106. *See generally id.* ¶¶ 49-85 (outlining the pattern of racketeering activity that Madoff executed with BMIS and DePasquale).

107. *See id.* ¶ 67.

108. *See generally* Complaint ¶¶ 87-97, *MLSMK Inv. Co.* (explaining the extent to which Chase had knowledge of Madoff's fraudulent behavior and how Chase played a necessary role necessary in helping Madoff execute his operations).

The commercial bad faith and negligence claims arise out of the same operative allegations–Chase continued to provide Madoff with banking and financial services after it knew Madoff was operating a Ponzi scheme.[109] By failing to act on this information, MLSMK contends, Chase was negligent.[110]

2. *Padrick v. Umpqua Bank*[111]

Much like the MLSMK plaintiffs, bankruptcy trustee Kevin Padrick brought claims for civil conspiracy and aiding and abetting breach of fiduciary duty based on Umpqua Bank's actual knowledge or awareness of the alleged wrongdoing.[112]

Padrick alleged that four Summit shareholders operated a Ponzi scheme in connection with Summit's Section 1031 exchange business.[113] By 2006, Umpqua was the primary depository institution for Summit's client deposits.[114] In early 2007, the Summit shareholders, in face-to-face meetings and in telephone conferences, "described in great detail all relevant aspects of their Ponzi scheme and embezzlement," including their business model and the diversion of funds to an affiliate company and to Umpqua.[115] The complaint alleged that, despite being informed of this fraud, Umpqua officials continued to assist Summit and its shareholders by allowing them to use Umpqua bank accounts and encouraging them to transfer additional funds to Umpqua.[116]

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109. *See generally id.* ¶¶ 99-133 (outlining the different ways in which Chase continued to act as Madoff's bank even after Chase discovered the illegitimacy of Madoff's investment returns).

110. *See id.* ¶ 130.

111. Complaint, No. 0906-08488 (Cir. Ct. Or. 2009).

112. *See id.* ¶ 1; *see also* Complaint, *MLSMK Inv. Co.* (alleging that Chase was liable for racketeering, aiding and abetting breach of fiduciary duty, commercial bad faith, and negligence against defendants).

113. Complaint ¶ 4, *Padrick*; *see supra* pp. 33-34.

114. Complaint ¶ 10, *Padrick*.

115. *Id.* ¶ 12.

116. *Id.* ¶¶ 13-14.

B. *Allegations of Unwitting or Indirect Participation in a Ponzi Scheme*

In addition to being subjected to liability for what they actually knew, financial institutions are increasingly facing litigation for indirectly participating in Ponzi schemes. The cases below demonstrate that financial institutions often face substantial litigation risk due to their unwitting involvement in fraudulent activity about which the financial institutions allegedly should have known.

1. *Fine v. Sovereign Bank*[117]

David J. Fine brought suit on behalf of an investor class against Sovereign Bank (Sovereign) for allegedly accepting funds deposited by a Ponzi scheme operator, Bradford C. Bleidt.[118] The complaint alleged that Sovereign knew or should have known that the Allocation Plus Asset Management Company, Inc. (APAM) account was being used for fraudulent or improper activities.[119] Notably, the plaintiffs alleged that Sovereign knew or should have known that the APAM account was not being used for legitimate investor deposits because: (1) statements for the APAM account were being sent to Bleidt's home and not the business's address; (2) the account was a personal account as opposed to a commercial account, as required by the SEC; (3) Bleidt was the only person authorized to do anything with the APAM account; (4) there was a second, "legitimate" APAM account at Fleet Bank that Sovereign knew about; and (5) there were many indicators that Bleidt was not using the investors' money for legitimate purposes.[120]

The claims against Sovereign included: (1) aiding and abetting breach of fiduciary duty; (2) taking instruments with notice of breach of fiduciary duty; (3) negligence in permitting Bleidt to act beyond the scope of his authority; (4) negligence in

117. Amended Complaint, No. 06-cv-11450-NG (Mass. Dist. Ct. filed Dec. 7, 2006).

118. *See id.* ¶ 24.

119. *See id.*

120. *Id.*

permitting Bleidt to shield his fraudulent conduct from the SEC; (5) violations of the consumer protection laws of Massachusetts; and (6) conversion.[121]

The court denied summary judgment because an issue of fact existed regarding actual knowledge. In December 2008, a jury found in favor of Sovereign on all claims.[122] Thereafter, Fine filed a motion for new trial, which the court granted in part as to the conversion claim and denied as to the other claims.[123]

2. *Inversiones Mar Octava Limitada v. Banco Santander S.A.*[124]

In *Inversiones Mar Octava Limitada v. Banco Santander S.A.*, a class action case, investors sued Banco Santander (Santander) alleging liability based on Santander's "indirect" investments in Madoff Investments.[125] Santander, the complaint alleged, marketed two funds to investors after allegedly conducting "intensive due diligence."[126] The investors claimed that proper due diligence by the defendants would have revealed that Madoff was a fraud.[127] Accordingly, the plaintiffs alleged that Santander should have known that it was participating in a massive Ponzi scheme and thus should be liable.[128]

The plaintiffs based their suit on alleged violations of the Securities Exchange Act of 1934.[129] Plaintiffs also asserted claims for breach of fiduciary duty, gross negligence, negligent misrepresentation, unjust enrichment, and professional malpractice.[130]

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121. *See id.* ¶ 1.

122. *Id.*

123. *See* Fine v. Sovereign Bank, No. 06cv11450-NG, 2009 WL 4250076 *1 (D. Mass. Nov. 27, 2009).

124. Complaint, No. 1:09-cv-20215-PCH (S.D. Fla. filed Jan. 26, 2009).

125. *See id.* ¶¶ 1-2.

126. *Id.* ¶ 34 (quotation omitted).

127. *Id.* ¶¶ 44-52.

128. *See generally id.* (describing the many "red flags" that should have signaled that Madoff's investment operation was a Ponzi scheme).

129. *Id.* ¶¶ 6, 58-90; *see* 15 U.S.C. § 78a (2009).

130. Complaint ¶¶ 58-90, Inversiones Mar Octava Limitada v. Banco Santander S.A., No. 1:09-cv-20215-PCH (S.D. Fla. filed Jan. 26, 2009).

3. *Grossbard v. Securities America, Inc.*[131]

In *Grossbard v. Securities America Inc.*, a class led by Ilene Grossbard sued Securities America, Inc., Securities America Financial Corporation, and Ameriprise Financial, Inc. for allegedly participating in a Ponzi scheme when the financial institutions should have known it was a massive fraud.[132] Specifically, Grossbard alleged that the financial institutions

> failed to perform due diligence that would have revealed that [the fund] was a fraud; or . . . performed due diligence and recklessly and/or negligently failed to discover . . . [the] fraud; or . . . performed due diligence and came to appreciate . . . [it] likely was a Ponzi scheme.[133]

Grossbard and the class brought claims for negligence, violations of the Nebraska Blue Sky law, negligent misrepresentation, and fraudulent misrepresentation.[134]

C. *Fraudulent Transfer Claims*

1. *Rotstain v. Trustmark National Bank*[135]

In the aftermath of the SEC's case against Allen Stanford and Stanford Financial Group,[136] a putative class of aggrieved investors filed suit against five banks for their alleged roles in facilitating Stanford's sale of fraudulent certificates of deposit.[137]

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131. Complaint, No. 8:09-cv-00350-JFB-TDT (D. Neb. Filed Oct. 10, 2009).

132. *See id.* ¶ 1. The defendants allegedly sold millions of dollars worth of notes for a medical services company that turned out to be running a $2 billion Ponzi scheme. *Id.*

133. *Id.* ¶ 20.

134. *Id.* ¶¶ 47-74.

135. Complaint, No. 3:09-cv-023484-N (N.D. Tex. filed Nov. 13, 2009) (removed from the 129th Judicial District Court of Harris County, Texas to the District Court for the Southern District of Texas, No. 4:09-cv-03673, and transferred to the Northern District of Texas).

136. *See supra* pp. 32-33.

137. *See* Complaint, *Rotstain* at 1-2.

The plaintiffs alleged that the banks, while not directly involved in the sale of the certificates of deposit, acted as "willing and essential conduits for the flow of money from Stanford's unsuspecting victims to Stanford's criminal enterprise."[138] The plaintiffs contended that each bank either knew or should have known that Stanford's operation was illegitimate. Despite this alleged knowledge, the banks continued to conduct business for Stanford and earned significant fees in the process.[139]

In an effort to force the banks to disgorge their fees, the plaintiffs filed claims under the Texas Uniform Fraudulent Transfer Act for conspiracy to commit fraud and aiding and abetting fraud.[140] According to the complaint, the banks were paid with funds stolen from the plaintiffs.[141] Furthermore, the plaintiffs alleged that these funds were paid to the banks pursuant to a scheme and with the actual intent to hinder, delay, and defraud the plaintiffs and other members of the class without having paid reasonably equivalent value, and at a time when Stanford was insolvent or nearing insolvency.[142]

2. *SEC v. Madison Real Estate Group, LLC*[143]

In *SEC v. Madison Real Estate Group, LLC*, the SEC sought to invalidate real estate loan transactions with Fannie Mae, Midland Loan Services, Inc., and Crown NorthCorp., Inc., under the UFTA.[144] The SEC complained that Madison Real Estate Group and three individuals wrongfully solicited and obtained investments from the fraudulent sale of limited partnership interests in a number of apartment complexes.[145] The complaint alleged that the returns paid to investors came from newly-invested funds from other investors.[146] The court appointed a

138. *See id.* at 2.
139. *See id.* at 3-4.
140. *See id.* at 23-26.
141. *See id.* at 4.
142. *See id.*
143. 647 F. Supp. 2d 1271 (D. Utah 2009).
144. *See id.* at 1279 n.33 (noting that the fraudulent transfer claims were brought under the UFTA, as adopted by both Texas and Utah).
145. *Id.* at 1275-1279
146. *Id.*

receiver to take control of and marshal the defendants' assets, including the apartment complexes.[147]

Both the SEC and the receiver moved to invalidate the loan transactions under the UFTA because the collateral was pledged, or transferred, from a Ponzi scheme.[148] The court, however, found that the lenders acted in good faith and gave reasonably equivalent value in exchange for their security interests.[149] The court held that contracts arising from a Ponzi scheme are "unenforceable to the extent they purport to give persons a right to payments in excess of their initial undertaking," but these lenders acquired the loans from other lenders and gave reasonably equivalent value for the notes and trust deeds they held.[150] Thus the loan transactions were not voidable.[151]

3. *Janvey v. Alguire*[152]

In a companion case to the SEC's case against Allen Stanford and Stanford International Bank (SIB), Ralph Janvey, the court-appointed receiver for SIB brought disgorgement claims against a number of relief defendants in *Janvey v. Alguire*.[153] The receiver sued to recover proceeds, including interest and principal redemptions, from the relief defendants, who benefited from the sale of fraudulent SIB certificates of deposit (CDs).[154] Among the

147. *See id.*

148. *See id.* at 1275.

149. *See Madison Real Estate Group, LLC*, at 1281-82.

150. *Id.* at 1280.

151. *See id.* at 1279.

152. Receiver's First Amended Complaint Against Certain Stanford Investors, Janvey v. Alguire, No. 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009).

153. *Id.* "Relief defendants" are not defendants or even real parties in interest in the traditional sense. *See* SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991). Often they are custodial banks or innocent investors who merely received or are holding payments distributed under a Ponzi scheme. *See generally* SEC v. Cavanagh, 155 F.3d 129, 136 (2d Cir. 1998) (explaining how federal courts can order equitable relief against an individual in a securities enforcement where the person has received "ill-gotten" funds and "does not have a legitimate claim to those funds"). A finding that a relief defendant has received funds to which he has no legitimate claim, even if it only served as custodian, may subject the relief defendant to a disgorgement order. *See* SEC *v.* Colello, 139 F.3d 674, 678 (9th Cir. 1998).

154. Receiver's First Amended Complaint Against Certain Stanford Investors, Janvey v. Alguire, ¶ 42, No. 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009).

named relief defendants were investors, but also certain "Custodian Relief Defendants" and financial institutions that held CD proceeds in a trust capacity for SIB investors.[155] The receiver later amended his complaint to allege claims for fraudulent transfers.[156]

Through his amended complaint, the receiver seeks disgorgement of CD proceeds from certain Stanford investors, as well as from former Stanford employees, on fraudulent transfer and unjust enrichment theories.[157] To defeat the receiver's fraudulent transfer claims, the defendants must establish the affirmative defense of both objective good faith and reasonably equivalent value.[158] As the case is ongoing, only time will tell whether the receiver will actually recover CD proceeds under these or any other theories.

D. Defending Against Ponzi Scheme Litigation

A financial institution's liability generally hinges on whether the plaintiffs can prove that the financial institution had actual knowledge of the Ponzi scheme. Therefore, a financial institution's defense to Ponzi scheme litigation should intensively focus on establishing that the financial institution did not have actual knowledge of the underlying fraud.[159] At least one court has

155. *See id.*

156. *See generally id.* (explaining how the Stanford Investors were unjustly enriched from fraudulent CD proceeds).

157. *Id.* ¶ 42 (showing how the Receiver is entitled to disgorgement because payments to Stanford Investors were fraudulent or, in the alternative, because Stanford Investors was unjustly enriched); Receiver's Second Amended Complaint Against Certain Stanford Employees, ¶¶ 34, 42, Janvey v. Alguire, No. 3:09-CV-00724-N (D. Tex. filed Dec. 12, 2009) (showing how the Receiver is entitled to disgorgement because payments to Stanford Investors were fraudulent or, in the alternative, because Stanford Investors was unjustly enriched).

158. *See generally* Receiver's First Amended Complaint Against Certain Stanford Investors ¶¶ 34-35, Janvey v. Alguire, No. 03:09-CV-0724-N (outlining the defenses available to the defendant); Receiver's Second Amended Complaint Against Certain Stanford Employees ¶¶ 36-37, Janvey v. Alguire, No. 03:09-CV-0724-N (outlining the defenses available to the defendant).

159. Amended Complaint ¶ 41, Fine v. Sovereign Bank, No. 06CV1450-NG (D. Mass. Aug. 8, 2008) (order denying Plaintiffs' Motion for summary judgment) ("To prove that Sovereign aided and abetted Bleidt's actions, the receiver must show that it knew of the breach of fiduciary duty. . . . Similarly, to succeed on the negligence claim, the receiver must demonstrate 'actual knowledge' of the misappropriation.").

held that actual knowledge is an issue of fact, suggesting that a financial institution cannot dispose of claims at the summary judgment stage of scheme litigation.[160]

Defending against fraudulent transfer claims may also prove difficult. Once the existence of a Ponzi scheme is proven, a presumption of actual intent to hinder, delay, or defraud attendant to any transfer from the Ponzi scheme is established.[161] Therefore, to successfully defend against a fraudulent transfer claim, a financial institution must prove that it acted in good faith and gave reasonably equivalent value in exchange for the transfer.[162] With regard to investors, several courts have held that in the context of a Ponzi scheme, "a debtor does not receive reasonably equivalent value for any payments made to investors that represent 'false profits.'"[163] This rule could arguably apply to a financial institution that holds funds from a trustee or similar custodian. One court has defined "reasonably equivalent value" in this context as follows:

> up to the amount that "profit" payments return the innocent investor's initial outlay, these payments are settlements against the defrauded investor's restitution claim. Up to this amount, therefore, there is an exchange of "reasonably equivalent value" for the defrauded investor's outlay.[164]

Moreover, courts do not treat "false profits" as "profits" in the traditional sense of the word, but consider "false profits" to be the monies paid out by a Ponzi scheme to old investors to encourage further investment and sustain the fraudulent scheme.[165] Thus, a financial institution should focus its defense on establishing that it acted in good faith and gave reasonably equivalent value for the transactions at issue.

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160. *Id.* ¶ 42.

161. *See* SEC v. Madison Real Estate Group, LLC, 647 F. Supp. 2d 1271, 1279-80 (D. Utah 2009).

162. *See id.* at 1279-81.

163. *Id.* at 1279–80.

164. *See* Donell v. Kawell, 533 F.3d 762, 777 (9th Cir. 2008).

165. Drenis v. Haligiannis, 452 F. Supp. 2d 418, 422 (S.D.N.Y. 2008).

V. PROPOSED LEGISLATION THAT MIGHT AFFECT SCHEME LIABILITY[166]

In a recent effort to increase corporate responsibility, Congressional leaders introduced a bill known as the Investors' Rights and Corporate Accountability Act of 2009 (Bill).[167] Among other things, the Bill seeks to expand aiding and abetting liability by adding to the Securities Exchange Act of 1934 a substantial assistance standard of care.[168] Specifically, the Bill provides:

> [A]ny person that provides substantial assistance to another person, with reckless disregard for whether the substantial assistance is in violation of this title, or of any rule or regulation issued under this title, shall be liable in a private action brought under this title, to the same extent as the person to whom the substantial assistance is provided.[169]

In the economic context of a Ponzi scheme, the language of "scheme liability" refers to claims based on deceptive conduct and manipulative acts and practices rather than on material misrepresentations or omissions.[170] As of the publication date of this Article, the Bill had been referred to the Senate Committee on Banking, Housing, and Urban Affairs[171] and may emerge with similar provisions or in some form of a compromise. Nonetheless, Congress appears clearly interested in expanding liability to, among others, third parties and licensed professionals who are involved in the economic transactions that are later determined to have been a "scheme." This legislation could abrogate the Supreme Court's holding in *Stoneridge Inves. Partners, LLC v. Scientific-Atlanta, Inc.*, which severely restricted aiding and abetting liability.[172]

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166. Scheme liability refers to claims based on deceptive conduct and manipulative acts and practices rather than on material misrepresentations or omissions. *See, e.g., In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006).

167. *See* S. 2813, 111th Cong. (2009).

168. *Id.* § 7 (emphasis added).

169. *Id.*

170. *See, e.g., In re Enron Corp.* 423 F. Supp. 2d at 723.

171. Investors Rights and Corporate Accountability Act, S. 2813, 111th Cong. (2009), *available at* http://thomas.loc.gov/cgi-bin/query/z?c111:s.2813:.

172. Stoneridge Inv. Partners, LLC v. Scientific-Atlantic, Inc., 552 U.S. 148, 148 (2008) ("Although *Central Bank* prompted calls for creation of an express cause of

In *Stoneridge*, the Court upheld the principle enunciated in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[173] that claimants may pursue actions under Section 10(b) of the Securities Exchange Act of 1934 against "secondary actors who commit primary violations" of the securities laws.[174] To resolve a circuit-court split over whether Section 10(b) applied to secondary actors such as accountants, lawyers, or banks, the *Central Bank* Court held that it was not Congress's intent to extend the "directly or indirectly" language of Section 10(b) to aiding and abetting claims.[175] The Court reasoned that doing so would improperly extend aiding and abetting liability to persons who did not actually engage in a deceptive act or practice.[176] The *Stoneridge* Court once again refused to find a private right of action for aiding and abetting, holding that Congress must decide whether to extend a private cause of action for aiding and abetting.[177] Thus, both cases

action for aiding and abetting, Congress did not follow this course. Instead, in § 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), it directed the SEC to prosecute aiders and abettors. Thus, the § 10(b) private right of action does not extend to aider and abettors.").

173. 511 U.S. 164 (1994).

174. *See Stoneridge,* 552 U.S. at 166; *see also Central Bank of Denver*, 511 U.S. at 191 (holding that "[b]ecause the text of § 10(b) does not prohibit aiding and abetting . . . a private plaintiff may not maintain an aiding and abetting suit under § 10(b). The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities laws. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.").

175. *See Central Bank of Denver*, 511 U.S. at 175-76.

176. *See id.* at 176-177.

177. *See Stoneridge*, 552 U.S. at 164-65.

found that it was the exclusive right of the SEC—and not private litigants—to enforce aiding and abetting liability.[178]

The proposed Bill, as well as a similar bill proposed by Sen. Arlen Specter, could effectively abrogate the Court's holdings in *Central Bank* and *Stoneridge* by allowing private actions under aiding and abetting liability.[179] As proposed, the Bill would potentially expand liability to the lawyers, accountants, and banks that would otherwise be beyond reach of private aiding and abetting claims. The Bill also proposes a "reckless disregard" standard, which could be easier to prove than the "actual knowledge" standard required under a Section 10(b) claim.[180]

As proposed, the Bill could effectively remedy what some commentators have argued is, after *Stoneridge*, a toothless secondary liability statute. In the eyes of one commentator, the Court's decision in *Stoneridge* effectively thwarted the basic tenet of securities laws, which is to protect the investing public from manipulations and frauds whose sole purpose is to enhance stock prices to the detriment of investors.[181] In holding that secondary actors–who themselves do not make fraudulent statements–cannot be held liable for assisting a securities issuer in committing a fraud, the Court "essentially provided an incentive for companies to assist one another in developing complex fraudulent business transactions."[182]

While the Bill may widen the scope of scheme liability and deter the incentive for developing fraudulent business transactions, it may also increase litigation against lawyers,

178. *See id.*; *see also Central Bank of Denver*, 511 U.S. at 191 (holding respondents could not maintain a private action against petitioner for aiding and abetting another's use of a manipulative device).

179. *Compare* S. 1551, 111th Cong. (2009) ("For purposes of any private civil action implied under this title, any person that knowingly and recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided.") *with* S. 2813, 111th Cong. (2009) (proposing a "reckless disregard" standard).

180. *See Central Bank of Denver*, 511 U.S. at 190 (standard of actual knowledge). S. 1551, as proposed, would institute a "knowingly and recklessly" standard for aider and abettor liability. S. 1551, 111th Cong.

181. *See* Stefan A. Dann, *The Supreme Court Narrows Secondary Actor Liability By Abrogating Scheme Liability: Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, 47 DUQ. L. REV. 391, 406 (2009).

182. *Id.*

accountants, banks, and others who unwittingly provide assistance to Ponzi schemes or to other securities law violators. In theory, the Bill's proposed, less stringent "reckless disregard" standard could subject actors like those in *Banco Santander* and *Grossbard* to liability in common commercial transactions where they "should have known" of a fraud. Given recent calls for greater oversight and accountability from financial institutions following the credit crisis and revelations of gross misconduct by investment managers who became Ponzi scheme operators, such as Madoff and Stanford, the passage of the Bill or some variation thereof seems increasingly likely.[183]

VI. CONCLUSION

This article offers insight into the types of claims that financial institutions may face when a Ponzi scheme collapses. In the current economic climate, claims against financial institutions will no doubt increase. And, in the aftermath of a Ponzi scheme's collapse, financial institutions, whether direct or indirect participants, will almost certainly face litigation risks for even the most remote involvement in financial frauds. Recent litigation shows that aggrieved investors are becoming increasingly creative, and they are pursuing any solvent entity—especially financial institutions—that may have played a role. With a stagnant economy and growing public outrage over the lack of oversight and accountability within the financial industry, these trends may become a pattern.

Financial institutions would be well advised to take steps to review and evaluate their potential exposure to scheme liability as best they can. A thorough due diligence review of business practices could help to defend against a claim that a financial institution "knew or should have known" they were dealing with a Ponzi scheme. In the event that the Bill or similar aiding and abetting legislation is passed, such due diligence may be useful in defending against claims that a financial institution acted with

183. *See generally SEC Officials Promise Changes After Madoff Failure*, CRAIN'S N. Y. BUS., Sept. 10, 2009, http://www.crainsnewyork.com/article/20090910/FREE/ 90 9109995 (showing how the Madoff scandal has led to calls for change and revamped enforcement efforts at the SEC).

"reckless disregard." In either respect, financial institutions and learned professionals should be increasingly vigilant about knowing their customers and those with whom they are doing business.