Allen Matkins

*Investor Alert*

# Swindled But Still Liable – An Innocent Ponzi Scheme Investor May Have To Pay Back Funds Received


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A Ponzi scheme is a financial fraud that operates by transferring funds received from new investors to previous investors under the fiction that the funds being transferred are profits from a legitimate enterprise. Thus, as long as new investors continue to be lured into the fraud, the earlier investors are kept happy with fictitious profits. When the chain of investment is stopped, however, the early investors may be surprised to learn that they can be held liable for the "profits" on their "investment".

In a recent typical case, Mr. K. and his mother were among thousands of investors in a Ponzi scheme that was shut down by the Securities and Exchange Commission. A receiver was appointed who filed a complaint in federal court seeking to recover payments from Mr. K. even though the receiver did not allege that Mr. K. had been complicit in the fraudulent scheme. Instead, the receiver sued under the Uniform Fraudulent Transfer Act as adopted by California (the "UFTA"). The receiver alleged both actual fraud and constructive fraud, not on the part of Mr. K., but on the part of the defunct scheme.

Under the UFTA, courts have generally followed a two-step process. First, they determine whether an investor is liable by netting the amounts transferred by the Ponzi scheme to the investor against the amounts invested. If the net is positive, there is liability. However, the actual amount of liability is determined by the court based on a number of factors such as the statute of limitations and the lack of good faith on the part of the investor. If the net is negative, the good faith investor is not liable and may file a claim against the receivership estate for the net negative amount. Second, to determine the actual amount of liability, the courts generally permit an investor to retain up to the amount of their actual investment not including the "rollover" of paper profits and require repayment of only the "real" profits.

In the case of Mr. K., he had invested $23,000 and received back approximately $73,000. Although Mr. K. had a positive net of $50,000, he was not found liable for this amount. The court limited his liability to the payments received within the applicable statute of limitations. As a result, the court entered judgment for $26,000 plus pre-judgment interest.

On appeal, Mr. K. offered a number of legal theories as to why he, an innocent investor, should not be liable to return any amount. The Ninth Circuit Court of Appeals considered and rejected each of these theories. Indeed, the appellate court found that Mr. K. had been treated fairly under the California UFTA - noting that Mr. K. received a return on his investment while most of the other investors are likely to receive only pennies on the dollar of their investment.

California fraudulent transfer law is not the only basis on which profits can be recovered. Federal equitable theories asserted by receivers also include disgorgement of ill-gotten gains, unjust enrichment and constructive trust.

It is clear that the pain for investors in a Ponzi scheme may not end when the fraud is uncovered. They may be called upon to return monies even though they were innocent of any wrongdoing and they have already spent the "profits".

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