

Bernie Madoff After Ten Years; Recent Ponzi Scheme Cases, and the Uniform Fraudulent Transactions Act

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Remember Bernie?

Ten Years Later. On December 11, 2018, the *Motley Fool* (<https://www.fool.com/investing/2018/12/11/3-lessons-from-bernie-madoffs-ponzi-scheme-arrest.aspx>) published an article commemorating the tenth anniversary of Bernie Madoff's arrest in 2008. Prior to his arrest, Madoff was a well-respected leader of the investment community, a significant charitable benefactor, and a Wall Street giant. That changed when Madoff was arrested and his financial empire was revealed to be the biggest Ponzi scheme in history. In March 2009, Madoff pleaded guilty to 11 different felony charges, including money laundering, perjury, fraud, and filing false documents with the Securities and Exchange Commission. Madoff was sentenced to 150 years in federal prison where he remains today at the age of 80. Five of his employees were also convicted and are serving prison sentences, one of his sons committed suicide in December 2010, and his wife Ruth's lifestyle changed dramatically. (In his plea deal with prosecutors, Ruth was allowed to keep \$2.5 million for herself.) [<https://nypost.com/2017/05/14/the-sad-new-life-of-exiled-ruth-madoff/>]. All of this was chronicled in *The Wizard of Lies*, a 2017 made-for-television movie starring Robert DeNiro as Bernie Madoff and Michelle Pfeiffer as Ruth Madoff. [<https://www.imdb.com/title/tt1933667/>].

The Madoff Ponzi Scheme. Bernie Madoff and his sons, as we recall, managed a multibillion dollar Ponzi scheme over a large number of years from Bernie's Manhattan offices with investors all over the world and here in Colorado. [See Denver Post article on February 5, 2009, available at <https://www.denverpost.com/2009/02/05/high-profile-coloradans-on-list-of-madoffs-clients/>.] Over time, Madoff posted seemingly spectacular returns and was able to use that track record to attract more clients and assets. But in actuality, what he was doing was generating false paperwork to establish those returns and then paying off older investors with the money that new investors were giving him. That flow of money is the backbone of a Ponzi scheme, named after fraudster Charles Ponzi who famously swindled investors with the method in the 1920s. By making sure new money was always coming in, the scheme allowed early investors to get paid amazing profits – which in turn boosted its popularity and brought even more money from interested new investors.

If it sounds unsustainable, that's because it was unsustainable, as are all Ponzi schemes. At some point in the life of all Ponzi schemes, the "bigger fool" theory fails. [See, e.g., Lidstone, *Securities Law Deskbook* (CLE in Colorado 2018) at § 2.10 – *Pyramid and Ponzi Schemes*.] For Madoff, that fact became increasingly apparent as the U.S. financial system hit the financial crisis of 2008. The downward change of economic circumstances caused investors to raise cash wherever they could – which led to a rash of redemption requests from Madoff clients. These redemption requests came from investment funds and banking institutions to charitable organizations, pension plans and individuals. Madoff could not meet those requests,

and eventually he had no choice but to give up, confessing to his two sons that the enterprise they had all worked for over the years was essentially a \$50 billion fraud.

The Trustee's Recovery Actions. That, however, is not the end of the story for the global investors in Madoff's Ponzi scheme – either for those who made money or for those who lost money. Irving Picard, who was named bankruptcy trustee for Madoff's investment firm, has recovered \$13.3 billion since he started his work as court-appointed receiver in 2009. That amounts to approximately 70% of the \$19 billion in claims made by defrauded investors. [https://www.wsj.com/articles/the-amazing-madoff-clawback-1543620951 dated November 30, 2018 (by subscription to the *Wall Street Journal*)]. Much of the money has come from early investors in the Ponzi scheme who were not only paid but also profited handsomely due to Madoff's manufactured returns. Picard's clawbacks have been controversial, but they've ensured that later investors were not put at a disadvantage to earlier ones. As reported by the *Wall Street Journal* on November 30, 2018:

Mr. Picard won a key legal victory in August 2011, when the Second Circuit upheld the method he and his team devised to determine how to handle claims. Madoff investors who took out more money from the fund than they deposited would have no claim, and would instead be liable to return their Ponzi-inflated gains. Only net losers [based on the amount of their original investment – not expected earnings] would receive payments from money recovered by the trustee. As a result, there have been some “good-faith defendants,” as Mr. Sheehan calls them. “It's sort of a misnomer. We call them that because we don't have to prove they knew anything about the Ponzi scheme to get their money back. What they got was fictitious profit.”

Ponzi's In Colorado – Lewis v. Taylor

The Sean Mueller Scheme. The Madoff Ponzi scheme is far from the only Ponzi scheme that has impacted Colorado investors, and receivers are continuing to recover funds from Ponzi scheme winners for the benefit of Ponzi scheme losers. In December 2018, the Colorado Supreme Court handed down the latest of Ponzi decisions deriving from the Sean Mueller Ponzi scheme in which about 95 investors lost a total of approximately \$72 million from 2000 through 2010 when the scheme fell apart. [As reported by the Denver Business Journal on August 7, 2014, “According to a report filed by receiver C. Randel Lewis [in November 2013], 148 separate persons or entities invested about \$147 million with Mueller from 2000 to 2010. During its operation, Mueller's business paid out about \$86 million to investors, partly as false returns on investment and partly as return of principal.” See https://www.bizjournals.com/denver/morning_call/2014/08/ponzi-schemer-sean-muellers-victims-may-see-some.html.]

CUFTA and the Ponzi Scheme. Steve Taylor had invested \$3 million with Mueller's investment funds, and within thirteen months had recovered his entire investment plus \$487,305.29 in profit. There were multiple individual transfers made from the Mueller investment funds to Taylor between September 1, 2006 and April 19, 2007 (at which time Taylor had received a return of his investment and profit). The receiver brought legal action against Mr. Taylor under the Colorado Uniform Fraudulent Transfer Act (“CUFTA”), C.R.S. §38-8-105(1)(a) which provides that a “transfer made . . . by a debtor is fraudulent as to a creditor . . . if

the debtor made the transfer . . . [w]ith actual intent to hinder, delay, or defraud any creditor of the debtor.” C.R.S. § 38-8-109(1) contains an affirmative defense, providing that a “transfer . . . is not voidable under section 38-8-105(1)(a) against a person who took in good faith and *for a reasonably equivalent value*” [emphasis added by the Court].

The receiver agreed that Mr. Taylor was entitled to retain the return of his initial \$3 million investment, but must return the profit he had realized. Mr. Taylor defended based on arguments that he was an innocent investor and he had provided “reasonably equivalent value” in exchange for his profits.

On cross motions for summary judgment, the trial court ruled in favor of the receiver. In *Lewis v. Taylor*, 2017 COA 13, ___ P.3d ____, 2017 WL 526122 (Colo. App. Feb. 9, 2017), the Court of Appeals reversed the summary judgment. In its decision, the Court of Appeals found that the trial court should have considered the time value of the \$3 million that Taylor had invested when determining whether he had provided “reasonably equivalent value in exchange for his profits.” [*Id.* at ¶ 27]

The Supreme Court reversed the Court of Appeals. *Lewis v. Taylor*, 427 P.3d 796 (Colo. 2018). In reversing the Court of Appeals, the Supreme Court looked extensively at CUFTA. In reviewing CUFTA, the Supreme Court looked at the CUFTA definitions of “property”, “debt” and “Claim” (found in C.R.S. § 38-8-102, and § 38-8-104(1)): “Value is given for a transfer . . . if . . . property is transferred or an antecedent debt is secured or satisfied.”

Since Taylor was an equity investor with Mueller, he (like any other equity investor in any business) had no guarantee of any return – “even for the time value of their investments.” Consequently, when the Ponzi schemer pays an investor more than was invested, the Ponzi schemer does not satisfy an antecedent debt or claim as required in § 38-8-104(1) because the investor has no right to any return. Based on that conclusion, the Supreme Court found that an investor in an equity-based Ponzi scheme has no right to receive the time value of money.

The Supreme Court agreed, however, that the return to an innocent investor of his or her original investment satisfies CUFTA’s requirement that the payment is for “value” as payment of “‘an antecedent debt’: the claim for restitution or fraud that the investor would have against the debtor.”

In responding to the Court of Appeals’ decision, the Supreme Court agreed that where there was a contractual right to interest on an investment, it “creates a time value to money constituting reasonably equivalent value under the statute.” Since Taylor had no contractual right to interest, the Supreme Court held that any return to him above his investment amount was a fraudulent transfer under CUFTA.

The Dissent. Interestingly, Justice Hart dissented from the Supreme Court’s opinion based on her reading of CUFTA – that it requires an individual analysis of each transfer, not a consideration of the investment scheme as a whole. Furthermore, Justice Hart would have held that each time Taylor made a withdrawal request, he was vested in the amount withdrawn – thus the Mueller payment thereby satisfied an antecedent debt.

Automated Teller Machines, Ponzis, Referral Fees, and the California UVTA.

Equally interesting, on December 24, 2018, the Ninth Circuit Court of Appeals issued a decision holding that an investor in a Ponzi scheme who also received referral fees for the introduction of investors was subject to disgorgement under California's Uniform Voidable Transactions Act (Cal. Civ. Code § 3439, *et seq.*, the "California UVTA"). *Hoffman v. Markowitz*, No.17-56290, 2018 WL 6735199 (9th Cir. Dec. 24, 2018).

The Securities and Exchange Commission instituted a receivership action in 2014 resulting from a Ponzi scheme based on ATMs operated by National Automated Systems, Inc. ("NASI") and its two principals from 1999. From January 2013 through September 2014, NASI raised \$123 million in investor money through, what the SEC alleged were fraudulent offers and sales of securities in a Ponzi scheme. [*SEC v. Nationwide Automated Systems, Inc.*, Case No. 2:14-cv-07249-SJO-FFM (U.S. District Court for the Central District of California, filed September 30, 2014).]

In that case, the receiver, William Hoffman, filed a fraudulent transfer action against Howard Markowitz and related entities to recover \$1,778,007.50 in profits paid to Markowitz and his entities over a twelve-year period of time – an amount which included not only profits on the investment but also referral fees that NASI had paid to Markowitz. The March 2016 action under the California UVTA alleged that "the full Profit Amount is an actual and constructively fraudulent transfer . . . and is subject to immediate disgorgement to the Receiver." [*Hoffman v. Markowitz*, Case No. 2:16-cv-1972-SJO-FFM (U.S. District Court for the Central District of California, filed March 22, 2016).]

As the case developed, it was proven that NASI had paid Markowitz referral fees for referring friends and family to the NASI Ponzi scheme. These amounted to nearly \$750,000. The trial court had issued partial summary judgment to the receiver for recovery of the referral fees. *Hoffman v. Markowitz*, No. CV 16-1972 SJO (FFMx), 2017 WL 6940501 (C.D. Cal. July 26, 2017). The Ninth Circuit affirmed the grant of summary judgment holding that the referral fees paid to Markowitz for introducing investors to the Ponzi scheme "do not constitute 'reasonably equivalent value' and are thus subject to disgorgement" since the referral services "provided no value to NASI investors." *Hoffman v. Markowitz*, No.17-56290, 2018 WL 6735199 (9th Cir. Dec. 24, 2018). The concurring judge would have held the referral fees to be *per se* voidable since the "investment referrals only created new liabilities for investors and that the net effect was to deepen NASI's insolvency with each referred investment." *Id.* at *2 (D.W. Nelson, concurring). The other California UVTA issues remain outstanding in this case, including whether Markowitz must return simply the balance of his profit or the entire original investment.

Conclusion

The Colorado Uniform Fraudulent Transfer Act and its kin in other states remain a valuable tool to recover funds for investors by receivers in Ponzi schemes where there may not be any real recourse for individual investors. The 2019 general assembly is likely to see a repeal and updating of Colorado's Uniform Fraudulent Transfer Act and adoption, at least in part, of the Uniform Voidable Transactions Act in its place.