Authorized Reprint
Journal of TAXATION and REGULATION of FINANCIAL INSTITUTIONS
© CRI Civic Research Institute

Troubles With Ponzi Scheme Receivers: White Knights, Evil Zombies, and the Flight of Icarus

In the wake of Ponzi schemes, federal courts often appoint receivers to recoup stolen money for the benefit of the defrauded investors. A receiver's primary function is to claw back money that the Ponzi scheme paid to so-called winning investors and others. But the courts should supervise more closely—and in many instances may wish to preclude altogether—receiver actions for negligence or secondary liability, for example, lawsuits alleging that a financial institution aided and abetted the fraudsters. As the authors explain, allowing receivers to bring these secondary liability actions may not best serve the defrauded investors, whose interests may conflict with the receivers'. Moreover, such actions tend to impose undue burdens on defendants, as Ponzi scheme receivers routinely seek special treatment not available to other litigants.

ALEX C. LAKATOS AND E. BRANTLEY WEBB

Ponzi schemes are on the rise—or, at least since the Bernie Madoff scandal, they are back on the radar.[1] The U.S. Securities and Exchange Commission keeps a running list of examples on its website and considers "[c]urtailing Ponzi schemes and holding accountable the individuals responsible for these scams" to be "a vital component" of its enforcement program.[2]

In the wake of Ponzi schemes, federal courts continue to appoint receivers to recoup stolen money for the benefit of the defrauded investors. Such Ponzi scheme receivers "step into the shoes of" the very companies used to perpetuate the Ponzi scheme and, sometimes, into the shoes of the Ponzi schemers themselves.[3] By "stepping into the shoes" of these individuals and entities, the receivers acquire their rights and obligations. Having done so, the receivers may bring claims that the Ponzi scheme companies, or the Ponzi schemers themselves, would have standing to bring.[4]

Whenever a Ponzi scheme receiver recovers stolen money, *before* she distributes any assets to investors, the receiver may deduct her own fees and costs. Thus—like it or not—the losing investors pay the receiver to recover money for them. The investors, however, may have little or no role in selecting the receiver or instructing her on litigation strategy or the resolution of claims.

THE CLAWBACK RATIONALE FOR APPOINTMENT OF A PONZI SCHEME RECEIVER

The original rationale that courts developed for appointing a Ponzi scheme receiver was "to safeguard

[1] The Ponzi Scheme Blog, available at http://theponzibook.blogspot.com, typically identifies about 20 enforcement actions, investigations, or sentences per month in the United States. International Ponzi schemes are also common.

[2] SEC Enforcement Actions Against Ponzi Schemes, available at https://www.sec.gov/spotlight/enf-actions-ponzi.shtml.

Alex Lakatos is a partner in the Financial Services Regulatory and Enforcement practice at Mayer Brown LLP, and Brantley Webb is an associate in the firm's Litigation practice. They may be contacted at alakatos@mayerbrown.com and bwebb@mayerbrown.com, respectively. *The authors wish to thank their colleagues Archis Parasharami, Stephen Medlock, and Max Bonici for their assistance with this article.*

[3] 65 Am. Jur. 2d *Receivers* § 165 (2016) ("[R]eceiver stands in the shoes of the corporation or person whose property is in receivership, with exactly the same rights and obligations . . . as such person had at the inception of the receivership."); Armstrong v. McAlpin, 669 F.2d 79, 89 (2d Cir. 1983) ("[R]eceiver stands in the shoes of the person for whom he has been appointed.").

[4] Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429 (1972) (receiver is limited to "the same claim[s] that the [receivership entity] could have made had it brought suit prior to entering receivership").

the disputed assets, administer the property as suitable, and to assist the district court in achieving a final, equitable distribution of the assets if necessary."[5] In fulfilling these duties, the receiver, standing in the shoes of the Ponzi schemers and their companies, was best positioned to bring one particular and vital type of action: a clawback suit.[6]

In particular, if a Ponzi scheme entity ("Ponzi Ltd.") paid more money to some investors than those investors had contributed to the scheme (so-called "winning investors," who received "fictitious profits"), then Ponzi Ltd., once it was controlled by the receiver, would be better positioned than the losing investors to recover the overpayments and ensure their equitable distribution.[7]

> Receivers now regularly bring suits against third parties, especially financial institutions, alleging that the defendants were negligent in failing to detect and prevent the Ponzi scheme, or that the defendants aided and abetted the Ponzi scheme.

Similarly, if Ponzi Ltd. took investor money and deposited it with a financial institution (especially one outside of the United States), then Ponzi Ltd. would be best positioned to get the money back from the financial institution after the scheme has unraveled. Once a receiver has taken control of Ponzi Ltd., that receiver can take advantage of the fact that Ponzi Ltd. is a signatory on the account at the financial institution, and perhaps even recover money on deposit without litigation. Or the receiver can recover the money that Ponzi Ltd. deposited or invested with the financial institution through any one of several causes of action, such as a contract suit pursuant to the deposit or investment agreement between Ponzi Ltd. and the financial institution. By contrast, because the investors are strangers to the relationship between Ponzi Ltd. and the financial institution, it would be more difficult for the investors themselves to recover.

PROBLEMS WHEN RECEIVERS GO BEYOND CLAWBACK ACTIONS

Receivers, however, have not limited themselves to bringing clawback actions. This may be motivated by, among other things, receivers' zeal to maximize investor recoveries, receivers' belief that the appointing court wishes them to bring such actions, or the financial rewards receivers enjoy when they expand their litigation portfolio. In any event, receivers now regularly bring suits against third parties, especially financial institutions, alleging that the defendants were negligent in failing to detect and prevent the Ponzi scheme, or that the defendants aided and abetted the Ponzi scheme. Thus, a receiver, standing in the shoes of Ponzi Ltd., would bring a suit against Bank, N.A., alleging that Bank, N.A., was negligent in failing to prevent Ponzi Ltd. from perpetrating the Ponzi scheme, or alleging that Bank, N.A., aided and abetted Ponzi Ltd. in committing the fraud.

Receiver actions for negligence and secondary liability should be supervised more closely than traditional receiver clawback actions, or barred outright. To bring such suits, the receiver must position Ponzi Ltd. as the *victim* of actions that actually helped Ponzi Ltd. perpetuate a Ponzi scheme. To measure damages in such a suit, the receiver must benchmark the losses of Ponzi Ltd., not the losses of the investors.[8] This often requires abundant use of legal fictions and bending the rules of evidence and civil procedure.

Indeed, allowing receivers to bring negligence and secondary liability suits against financial institutions and others creates a raft of problems. This article addresses several major concerns:

- The conflicts of interest that arise between receivers who may wish to pursue or conclude litigation

[5] Liberte Capital Grp., LLC v. Capwill, 462 F.3d 543, 551 (6th Cir. 2006) (citations omitted); Eberhard v. Marcu, 530 F.3d 122, 131 (2d Cir. 2008) ("We have observed that a primary purpose of appointing a receiver is to conserve the existing estate.").

[6] See, e.g., Wiand v. Schneiderman, 778 F.3d 917, 924 (11th Cir. 2015) (noting that the "underlying purpose of court-appointed receivers [is] pursuing clawback claims"); Eberhard, 530 F.3d at 131 ("Receivers appointed at the SEC's request are equipped with a variety of tools to help preserve the status quo while the various transactions are unraveled. . . . Receivers are directed to marshal the assets of the defendant."); Andrew Kull, "Common-Law Restitution and the Madoff Liquidation," 31(12) Bankr. L. Letter 2 (Dec. 2011) (arguing that trustee, like receiver, "is the ideal (indeed, the only) person to assert the collective state-law rights of net losers against net winners" in the wake of a Ponzi scheme).

[7] See, e.g., In re Petters Co., Inc., 440 B.R. 805, 806 (D. Minn. 2010) (explaining that through clawback actions, "a trustee or receiver puts all parties that transacted with the purveyor of a failed Ponzi scheme onto a parity in the matter of restitution" and "the property that . . . remain[s] in-hand with the purveyor as of the collapse, [is] augmented by recoveries of funds from those lenders and investors who got out early").

[8] *Marine Midland Grace Trust Co.*, 406 U.S. at 429 (receiver is limited to "the same claim[s] that the [receivership entity] could have made had it brought suit prior to entering receivership"); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 795 (6th Cir. 2009) ("[T]his Court has never objected to a receiver's stated goal of retrieving assets for the benefit of a receivership entity's creditors or customers, so long as the receiver only pursues claims that a receivership entity itself could have raised.").

Authorized Reprint
Journal of Taxation and Regulation of Financial Institutions
© CRI Civic Research Institute

on the one hand, and investors who are compelled to finance that litigation on the other;
- How an affirmative defense that bars fraudsters from suing others for the same fraud (the *in pari delicto* doctrine) has become muddled and has the potential for misapplication in suits brought by Ponzi scheme receivers; and
- The special treatment that receivers, as creatures created by court order, seek and sometimes are afforded in litigation, as well as how such special treatment can severely and unfairly prejudice the defendants.

Because receivers are creatures of equity that exist pursuant to court order, courts have considerable latitude in how they address the problems discussed in this article.[9] Courts may wish to consider, among other things, limiting the Ponzi scheme receiver's authority to recovering assets traceable to the Ponzi scheme entities, e.g., clawback actions.[10] They may wish to impose more rigorous judicial oversight. They may instruct receivers to consider input from Ponzi scheme investors when making certain strategic decisions. Ultimately, however, a legislative solution—if one can be enacted—may prove more effective, consistent and durable.

WHITE KNIGHTS? CONFLICTS OF INTEREST BETWEEN RECEIVERS AND INVESTORS

Ponzi scheme receivers typically portray themselves as white knights, rushing to the aid of hapless innocent investors unable to fend for themselves. The trouble for investors, however, is that receivers—consciously or unconsciously—may not put investor interests first.

It is the investors who have lost their money to the Ponzi scheme and to whom recoveries must ultimately be paid. Moreover, it is the investors who must finance litigation from the funds that the receiver recovers; that is, once the receiver recovers funds through litigation, the receiver's legal fees will be paid from those funds before the remainder is distributed to the investors. Losing investors have little, if any, say in how the receiver represents their interests. The receiver will decide whom to sue, whether to sue, what the litigation strategy will be, how much to spend on the suit, and whether and on what terms to settle. The receiver may choose to bring expensive and high-risk cases that have a slim chance of recovery. The losing investors' consent and direction is eliminated from the equation.

Similar Conflicts in the Securities Fraud Class Action Context. The problems that arise when lawyers (such as receivers) are free to direct litigation, untethered from the instructions of a client with a genuine financial interest in the outcome, has been explored in the context of class actions. Indeed, in the securities fraud class action context, the problem was eventually recognized as being sufficiently serious that legislation was enacted to address it.

The receiver will decide whom to sue, whether to sue, what the litigation strategy will be, how much to spend on the suit, and whether and on what terms to settle. The receiver may choose to bring expensive and high-risk cases that have a slim chance of recovery. The losing investors' consent and direction is eliminated from the equation.

Before 1995, the lead plaintiffs in securities class actions were often professional plaintiffs. They owned shares in myriad companies. They received bounties for acting as plaintiffs in securities fraud class actions filed by class counsel with whom they enjoyed a cozy relationship. Such professional plaintiffs had little money at stake, and little interest in monitoring and supervising the actions of class counsel. Class counsel representing these plaintiffs, by contrast, had huge fee awards on the line and free rein to manage the litigation to suit their own interests.

In response, in 1995 Congress enacted the Private Securities Litigation Reform Act (PSLRA).[11] In the words of the Report from the Senate Committee on Banking Housing and Urban Affairs (the "Senate Report") accompanying the PSLRA, "[t]he Committee

[9] See, e.g., United States v. Stonehill, 83 F.3d 1156, 1159 (9th Cir. 1996) (reviewing a district court's supervision of an equitable receivership for an abuse of discretion); SEC v. Black, 163 F.3d 188, 199 (3d Cir. 1998) ("[W]here there is a receiver with equitable power in a proceeding before it, the District Court has wide discretion as to how to proceed."); FDIC v. Bernstein, 786 F. Supp. 170, 177 (E.D.N.Y. 1992) ("[O]ne common thread keeps emerging out of the cases involving equity receiverships—that is, a district court has extremely broad discretion in supervising an equity receivership.").

[10] *Liberte Capital Grp., LLC*, 248 F. App'x at 650 (holding that receiver did not have general authority to take legal action on behalf of investors simply because receiver had authority to take charge of company's property to protect interests of investors).

[11] P.L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77z-1 (2000)) and Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78u-4)).

believes that the lead plaintiff—not lawyers—should drive the litigation."[12]

Accordingly, a central tenet of the PSLRA is the lead plaintiff provision. This provision creates a rebuttable presumption that the investor with the largest financial interest in the litigation should be lead plaintiff.[13] This, in turn, Congress anticipated, would help ensure that there was a plaintiff with the financial interest to monitor the conduct of the class action attorneys, control fees and costs, and inform strategic decisions, including whether to sue, whether to settle, and for how much. "At the heart of the lead plaintiff provision is Congress's belief that the securities class action needed an 'owner' of the suit's outcome."[14]

By putting interested plaintiffs rather than class counsel in the driver's seat, Congress aimed to solve a variety of problems that occur when lawyers make their own decisions without input from clients who have skin in the game. "Lawyer control of class actions coupled with the potential divergence between the interests of the lawyers and those of the class creates a risk that litigation decisions will not reflect the best interests of the plaintiff class or society as a whole."[15] At the forefront of Congress's concerns were the following:

- *Selection and Payment of Attorneys:* One area where the potential interests of securities fraud victims and attorneys may diverge is in the selection and compensation of counsel. A professional plaintiff with little economic interest in the amount of the recovery, a repeat relationship with the plaintiffs' law firm, and compensation guaranteed just for serving as lead plaintiff, had little incentive to comparison-shop for counsel or to push back on fees. By contrast, investors with a significant economic stake are more likely to seek the strongest counsel, to try to contain counsel fees and costs, and to make informed decisions balancing these interests. As one scholar cited in the Senate Report explains, "a court might well feel confident in assuming that a fee arrangement an institutional investor had negotiated with its lawyers before initiating a class action maximized those lawyers' incentives to represent diligently the class' interests, reflected the deal a fully informed client would negotiate, and thus presumptively was reasonable."[16] Indeed, post the PSLRA, institutional investors have proven routinely able to reach deals on attorneys' fees well below historical averages.[17] It should be noted, however, that the PSLRA is not a panacea, and problems with large repeat class action plaintiffs and attorneys wishing to represent them entering into abusive pay-for-play relationships have been observed.

- *Settlement Terms:* The interest of attorneys in reaching a settlement, and the interest of victims of securities fraud in reaching a settlement, can easily diverge. In the securities fraud class action context, for example, many attorneys work on a contingency basis and may need fast cash to stay afloat. "As such," prior to the PSLRA, "a settlement offer that provided recovery of the attorney's tangible and opportunity costs could loom larger than the prospect of aggressively pursuing the action to a more lucrative prospective judgment or settlement."[18] Congress sought to solve this problem by ensuring that settlement decisions would be governed by securities fraud victims rather than attorneys—and not just any victims, but those with the greatest economic interest in the recovery. As the Senate Report explains: "[i]nstitutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were 'fair and reasonable' than is the case with settlements negotiated by unsupervised plaintiffs' attorneys."[19] In other words, "[a] large investor has a financial incentive to prevent plaintiffs' counsel from selling out legitimate claims too easily; early settlement of strong cases on poor terms will not adequately compensate the lead plaintiff for its losses."[20]

[12] S. Rep. No. 104–98, at 10 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 689.

[13] See P.L. No. 104-67, § 101(a), § 27(a)(3) (amending 15. U.S.C. § 77z-1(a)(3)); id. § 101(b), § 21D(a) (3) (amending 15 U.S.C. § 78u-4(a)(3)).

[14] James D. Cox & Randall S. Thomas, "Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions," 106 Col. L. Rev. 1587, 1593 (2006).

[15] Jill E. Fisch, "Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA," 64 Law & Contemp. Probs. 53, 53 (2001).

[16] Elliott J. Weiss & John S. Beckerman, "Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions," 104 Yale L.J. 2053, 2105 (1995).

[17] See Keith L. Johnson, "Selecting Lead Counsel in the Midst of Judicial Chaos" 1, 2, Institutional Investor Advoc. (2001), available at https://www.blbglaw.com/news/publications/data/00065/_res/id=File1/3Q01Kjohnson.pdf.

[18] Cox & Thomas, supra note 14, at 1593.

[19] S. Rep. No. 104-98, at 11 (1995) (quoting Weiss & Beckerman, supra note 16).

[20] Jill E. Fisch, "Class Action Reform: Lessons From Securities Litigation," 39 Ariz. L. Rev. 533, 538–39 (1997).

Unfortunately, even in the wake of the PSLRA, plaintiffs' lawyers continued to abuse the class action mechanism and to find creative ways to circumvent legislative and judicial constraints. In 1998, Congress, concerned with ongoing misconduct including "manipulation by class action lawyers of the clients whom they purportedly represent,"[21] enacted the Securities Litigation Uniform Standards Act (SLUSA). SLUSA preempted certain state law claims for securities fraud. To curb further class action abuses both in and beyond the securities fraud arena, Congress enacted the Class Action Fairness Act (CAFA) in 2005. Among other things, CAFA provided for greater scrutiny of class action settlements, fostering judicial reduction of attorneys' fees disproportionate to the benefits, if any, that class members obtained. Nevertheless, abuses still abound.[22] Among myriad other concerns—but particularly relevant to this discussion—plaintiffs' lawyers (especially in the consumer context) continue to file class actions on behalf of clients with no meaningful economic interest in the outcome of the litigation, enriching only themselves.[23]

How the Issue Plays Out in the Ponzi Scheme Context. Given how difficult it has been to root out abuses in the class context, it is hardly surprising that the same types of problems are playing out in the context of Ponzi receivers who, on their own initiative, are bringing suits for negligence or secondary liability, e.g., aiding and abetting liability.

Conflict of Interest in Selection and Payment of Attorneys. In Ponzi schemes, receivers are often proposed to the court by the Securities and Exchange Commission,[24] which may make its selections through a bidding process that favors the low-cost provider. That certainly makes sense in the context of clawback actions. Clawback actions are fairly routine, commoditized services. The Ponzi schemers deposited or invested stolen money in the amount of $X in an account opened at Financial Institution Y, so typically Financial Institution Y will turn over $X from the account back to the receiver. Financial Institution Y may have no incentive even to oppose such a claim but need only ensure the claim is legitimate before returning the money, knowing the funds will go back to investors who were defrauded.

But in the complex world of speculative claims for secondary liability, investors may wish to select counsel based on considerations other than who is the lowest-cost provider. Moreover, when it comes to striking a deal on fees with an attorney who will engage in a complex and lengthy litigation, significant investors in Ponzi schemes have more incentive to find the most efficient agreement with counsel, and may be able to achieve more economical and effective deals by acting in their own self interest. As noted above, in the securities class action context, allowing the plaintiffs' lawyers with the largest plaintiffs to take the lead has led to collusion between large repeat plaintiffs and plaintiffs' class action lawyers willing to provide compensation for the privilege of being the lead attorneys—but that seems less likely to occur in the Ponzi scheme context, where plaintiffs typically are not repeat players and no procedural advantage is afforded to the lawyers whose clients are largest.

Conflict of Interest in Settlement Negotiations. Conflicts may also arise between the Ponzi scheme receiver and the losing investors when the receiver is considering whether to file and, later, whether to settle a weak case that alleges secondary liability. The receiver is typically paid by the hour, so it is in his or her economic interest to file such a suit and not to settle it readily. Other than this, a receiver's professional pride, and the need to report on her lawsuit and its resolution to the court that appointed her, may also forestall aggressive pursuit of settlement. By contrast, the investor may have an incentive to end expensive, "long shot" litigation sooner. Beyond stemming the outflow of legal fees to the receiver, there may be still other reasons the investors want to settle sooner—many victims of Ponzi schemes, sadly, can ill afford to wait years as lengthy litigation plays out before receiving distributions from the receiver. Under the current rules, Ponzi scheme receivers may even be tempted to delay distributing money obtained through clawback actions, wanting instead to use those funds to finance

[21] H. R. Rep. No. 104-369, p. 31 (1995).

[22] See. e.g., U.S. Chamber Institute for Legal Reform, Class Actions, available at http://www.instituteforlegalreform.com/issues/class-actions.

[23] Id.; Evan M. Tager, "Federal District Court: Attorneys Get Paid Even Though No Class Members Submitted Claims" (Mayer Brown Class Defense Blog, June 12, 2012), available at https://www.classdefenseblog.com/2012/06/gaylor-federal-district-court-approves-class-settlement-even-though-no-class-members-submitted-claims/; Archis A. Parasharami, "Sixth Circuit Rejects Class Settlement Over Excessive Payments to Class Counsel and Named Plaintiffs" (Mayer Brown Class Defense Blog, Aug. 13, 2013), available at https://www.classdefenseblog.com/2013/08/sixth-circuit-rejects-class-settlement-over-excessive-payments-to-class-counsel-and-named-plaintiffs/.

[24] Carl H. Loewenson, Jr. & Michael Gerard, "Court Appointed Receivers for Ponzi Schemes," 240(125) N.Y.L.J., Vol. 240-125 (Dec. 30, 2008), available at https://media2.mofo.com/documents/20081230nylj_ponzi.pdf.

secondary liability litigation. Investors who have been waiting a long time for the distribution of funds already collected by receivers would do well to inquire what the funds are being used for in the interim, and whether they share those objectives.

Conflict of Interest in Determining Whom to Sue. For Ponzi scheme receivers, there is yet another risk for serious conflict of interest that is far less of a concern where securities fraud is concerned. In the securities fraud context, it is often clear who the defendants will be: the company whose stock has dropped in price, and perhaps certain company officers.[25] By contrast, it is not uncommon for Ponzi schemers to have accounts at dozens of financial services companies. Any one of those companies may have deep pockets and, for that reason alone, be a tempting target for a secondary liability suit.

It is not uncommon for Ponzi schemers to have accounts at dozens of financial services companies. Any one of those companies may have deep pockets and, for that reason alone, be a tempting target for a secondary liability suit.

But Ponzi scheme receivers may be chosen *without regard* for whether they, their law firm, or any firm they hire, have conflicts with any of those financial institutions that might discourage or preclude them from bringing a suit alleging wrongdoing by that financial institution.[26] Ponzi scheme receivers may be appointed without any check on whether they count among their own clients the very financial institutions that the losing investors might wish to sue based on allegations of aiding and abetting. Ponzi scheme receivers are not obliged to inform the investors how they have selected the institutions they choose to sue, or not sue, for secondary liability. Discussions and choices that Ponzi scheme investors would enjoy if they had their own counsel are simply foreclosed. Under the current rules, there is no systematic way to guard against these conflicts.[27]

EVIL ZOMBIES: THE *IN PARI DELICTO* DEFENSE APPLIED TO RECEIVERS

In pari delicto in Latin means "of equal fault." The doctrine operates to prevent wrongdoers at who are equally culpable from recovering against one another. In other words, it "is the principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing."[28] It applies "to tortious transactions based upon fraud or similar intentional wrongdoing," as "[g]enerally, anyone who engages in a fraudulent scheme forfeits all right to protection, either at law or in equity."[29] The application of the *in pari delicto* doctrine is fairly straightforward where a fraudster sues another party for aiding and abetting his own fraud; courts routinely dismiss such cases.[30]

But what about where a Ponzi scheme receiver steps into the shoes of the fraudster, and in that capacity brings suit? *In pari delicto*, in context of a suit brought by a Ponzi scheme receiver, forces a choice among plaintiffs. If *in pari delicto* does not apply, the Ponzi scheme receiver, despite standing in the shoes of the fraudsters, can act as the plaintiff. If the doctrine does apply, the receiver cannot act as the plaintiff. In the latter case, the Ponzi scheme victims can bring the suit on their own: they are not wrongdoers, and they are not subject to the *in pari delicto* doctrine.

Some courts have applied the *in pari delicto* doctrine to suits by fraudsters, even after Ponzi scheme receivers have stepped into the fraudster's shoes. Others have not.

Waiving the Doctrine: The *Scholes* Decision. The most well-known case that waives the *in pari delicto*

[25] See generally Andrew J. Pincus, "What's Wrong With Securities Class Action Lawsuits? The Costs to Investors of Today's Private Securities Class Action System Far Outweighs Any Benefits," at 4 (U.S. Chamber Institute for Legal Reform, Feb. 5, 2014), available at http://www.instituteforlegalreform.com/uploads/sites/1/Securities_Class_Actions_Final1.pdf).

[26] A Ponzi scheme receiver may be able to avoid offending a financial institution that is the receiver's client if she brings only a clawback action. A secondary liability action, by contrast, is far more likely to sour the relationship between the receiver and a financial institution client.

[27] Defendants in third-party liability suits may be incentivized to spot any such conflicts of interest, but may face challenges convincing a court to unseat a long-serving receiver due to, among other things, the fact that they were not in a position to spot the conflict at the outset of the receiver's engagement. See, e.g., Sec. & Exch. Comm'n v. Nadel 2012 WL 12910270, at *6 (M.D. Fla. 2012) (holding that factors to be considered in resolving any conflict issues and determining whether to unseat a receiver include, among other things, the delay in the receivership case, the additional expense of appointing a new receiver, and the familiarity of the receiver with the details of the underlying government case and the related litigation).

[28] Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 837 (8th Cir. 2005) (quotation omitted).

[29] State by Head v. AAMCO Automatic Transmissions, Inc., 199 N.W.2d 444, 448 (Minn. 1972).

[30] 1A C.J.S. Actions § 68 (citing cases enforcing doctrine of *in pari delicto*).

doctrine is *Scholes v. Lehman*,[31] in which Judge Posner likened the Ponzi scheme entities to "evil zombies," until such time as the receiver released those entities from the fraudster's "spell"—an occurrence that Judge Posner held defeated the *in pari delicto* doctrine in a fraudulent conveyance case brought by a Ponzi scheme receiver:

> Though injured by [Ponzi schemer] Douglas, the corporations would not be heard to complain as long as they were controlled by him . . . because of their deep, their utter, complicity in Douglas's fraud. The rule is that the maker of the fraudulent conveyance and all those in privity with him—which certainly includes the corporations—are bound by it. But the reason, of course . . . is that [under the *in pari delicto* doctrine] the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls out now that Douglas has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of Douglas but of innocent investors—that Douglas had made the corporations divert to unauthorized purposes.[32]

Lifting the *in pari delicto* doctrine in a case like *Scholes*—i.e., so that the receiver can bring a fraudulent conveyance action—makes a certain amount of sense, as that is what receivers were intended to do, and what they do best. By contrast, lifting the *in pari delicto* doctrine so that the receiver can bring a secondary liability suit makes no sense, because as discussed above, it is not in victims' best interest for receivers to tread onto such shaky ground.

Judge Posner, in *Scholes*, clearly appreciated that the import of his decision was to force a choice concerning how the investors should pursue their claims. Immediately after holding that the *in pari delicto* doctrine would not bar receiver's claims, the *Scholes* opinion offers views on alternative means by which investors might pursue their claims, absent a receiver to take control. "The conceivable alternatives to these suits for getting the money back into the pockets of its rightful owners are," among others, "a series of individual suits by the investors, which, even if successful, would multiply litigation; a class action by the investors—and class actions are clumsy devices."[33]

First, Judge Posner is correct that class actions are clumsy devices, and would not be a prudent solution to the problems discussed in this article. Indeed, Judge Posner has authored a wealth of leading jurisprudence setting forth numerous flaws bedeviling class actions.[34]

Second, in stating that, absent a receiver, the investors acting of their own volition would bring "a series of individual suits," Judge Posner acknowledges that the investors' interests are not necessarily aligned with one another's or with the receiver's. That is, the investors likely would not bring a single action, and likely would not retain receiver as their counsel to bring the same suit. In other words, when a receiver is permitted to bring claims on behalf of a group of losing investors, the investors are being forced into a procedural posture akin to a class action, with all of their claims being resolved together through a single representative and all sharing in the recovery, but without even the *usual* protections even class actions afford, such as notice, the right to opt out, or the right to object to any settlement—let alone the heightened protections of the type implemented in the PSLRA. Accordingly, this is something that should be done sparingly, at most. While lifting *in pari delicto* to allow a receiver to pursue a fraudulent conveyance or clawback action may be sufficiently pragmatic to be justified, it is a bridge too far to apply the same

When a receiver is permitted to bring claims on behalf of a group of losing investors, the investors are being forced into a procedural posture akin to a class action, with all of their claims being resolved together through a single representative and all sharing in the recovery, but without even the *usual* protections even class actions afford, such as notice, the right to opt out, or the right to object to any settlement—let alone the heightened protections of the type implemented in the PSLRA.

[31] 56 F.3d 750 (7th Cir. 1995).

[32] Id. at 754 (citations omitted).

[33] Id. at 755.

[34] See e.g., In re Walgreen Stockholder Litig. 832 F.3d 718, 724 (7th Cir. 2016) ("The type of class action illustrated by this case—the class action that yields fees for class counsel and nothing for the class—is no better than a racket. It must end. No class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand."); Eubank v. Pella Corp., 753 F.3d 718 (7th Cir. 2014), Redman v. RadioShack Corp., 768 F.3d 622 (7th Cir. 2014); Pearson v. NBTY, Inc., 2014 WL 6466128 (7th Cir. Nov. 19, 2014).

reasoning in the context of a secondary liability or negligence suit.

Against Waiver: The *Knauer* Decision. In fact, in *Knauer v. Jonathon Roberts Financial Group, Inc.*,[35] the Seventh Circuit distinguished *Scholes* and held that the *in pari delicto* defense should be lifted only in cases of fraudulent conveyance. In *Knauer*, a receiver sued broker-dealers that licensed Ponzi fraudsters as securities representatives. The Seventh Circuit affirmed dismissal, concluding that "[t]he doctrine of *in pari delicto* . . . applies to defeat the receiver's claims."[36] The court explained:

> If the case before us involved the voiding of a fraudulent conveyance, as in *Scholes* . . . , we would likely apply *Scholes* . . . favoring exceptional treatment of receivers in those circumstances. This case, however, presents a different equitable alignment . . . [i]n the equitable balancing before us, we find *Scholes* less pertinent than the general . . . rule that the receiver stands precisely in the shoes of the corporations for which he has been appointed.[37]

Although *Knauer*'s reasoning is a bit different than that discussed above (*Knauer* focused on the choice of the defendant, rather than the choice of plaintiff), the Seventh Circuit nevertheless recognized the important distinction between cases where the receiver is acting in his or her wheelhouse, and cases where the receiver is not. That is the right result.

THE FLIGHT OF ICARUS: THE "SPECIAL" STATUS CLAIMED BY RECEIVERS

Icarus of Greek legend famously believed he should be exempt from the rules that bind other mortals. His resulting decision to fly too close to the sun on wax wings proved to be his tragic downfall.

Receivers seek special privileges across litigation they bring. For example, they may argue that because they are receivers, they are immune from and unanswerable for spoliation by the receivership entities. They may argue that they do not have to sit for Federal Rule of Civil Procedure 30(b)(6) depositions, and that defendants are limited to written discovery in receivership cases.

These arguments for not treating receivers like *ordinary* plaintiffs have a troubling result: If receivers are exempted from a plaintiff's ordinary burdens, defendants are denied the *ordinary* means of defending themselves. To the extent receivers succeed in lightening their own burden to prove their case, they necessarily increase the burden on defendants beyond what defendants would face in ordinary litigation.

Written Discovery vs. Depositions. Ordinarily, a defendant sued by a corporate entity is entitled to a "corporate" deposition under Rule 30(b)(6). Courts are typically very generous in granting parties' depositions and "regard the complete prohibition of a deposition as an extraordinary measure which should be resorted to only in rare occasions."[38] This general rule extends to Rule of 30(b)(6) depositions.[39]

Yet, receivers frequently argue that they should enjoy special consideration under the Federal Rules of Civil Procedure and ought not have to submit to a Rule 30(b)(6) deposition. In support of this, the receiver may argue that she had no involvement with the receivership entities before she was appointed and thus lacks the requisite knowledge needed to testify.

However, in contexts other than Ponzi schemes, courts routinely have rejected exactly this rationale. For example, courts have considered this position by the Federal Deposit Insurance Corporation (FDIC) when it acts as a receiver—and rejected it. In *FDIC v. Brudnicki*,[40] the district court allowed a defendant to take the Rule 30(b)(6) deposition of the FDIC, which was acting as a receiver for a failed financial institution.[41] The court held that "the FDIC's lack of personal knowledge of the pre-failure events occurring at the failed bank does not relieve the FDIC of its obligations to designate and produce a Rule 30(b)(6) deponent," it goes only to *reasonableness* of the topics noticed.[42] The court permitted the defendants to depose a representative of the FDIC (as receiver) on several topics including some that went to the

[35] 348 F.3d 230 (7th Cir. 2003).

[36] Id. at 238.

[37] Id. at 236.

[38] Jennings v. Family Mgmt., 201 F.R.D. 272, 275 (D.D.C. 2001) (internal quotation marks omitted); see also Salter v. Upjohn Co., 593 F.2d 649, 651 (5th Cir. 1979) ("It is very unusual for a court to prohibit the taking of a deposition altogether and absent extraordinary circumstances, such an order would likely be in error.").

[39] See, e.g., Lee v. Nucor-Yamato Steel Co. LLP, 2008 WL 4014141, at *3 (E.D. Ark. Aug. 25, 2008) (granting motion to compel deposition of Rule 30(b)(6) witness on topics which were "reasonably calculated to lead to the discovery of admissible evidence"); Floe Int'l Inc. v. Newman's Mfg. Inc., 2005 WL 6218040, at *5-6 (D. Minn. Nov. 9, 2005) (granting motion to compel Rule 30(b)(6) deposition).

[40] 2013 WL 5814494, at *2–3 (N.D. Fla. 2013).

[41] Id. at *2–3.

[42] Id. at *2.

conduct of the underlying entities before the FDIC was involved.[43]

Another rationale offered by receivers is that interrogatories are a more appropriate and less burdensome discovery vehicle than Rule 30(b)(6) depositions. This too is routinely rejected in other contexts. As one court has explained, a defendant should not be "precluded from conducting oral depositions merely because plaintiff considers them less than the optimal means of securing information."[44] Courts recognize that the in-person nature of discovery through deposition testimony—allowing a defendant to "probe and obtain elucidation of an answer"—provides "more complete information" than written interrogatories.[45]

Thus, if receivers successfully block deposition discovery, they deprive defendants of a critical form of discovery: in-person testimony that allows defendants to probe written answers, to follow up on unanswered questions, and to explore credibility issues.

Spoliation. Destruction of evidence can be one of the most significant issues in alitigation. "Documents create a paper reality we call proof. . . . If documents are lost or destroyed when they should have been preserved because a litigation was threatened or pending, a party may be prejudiced" and "the search for the truth" may be "stymie[d]."[46]

District courts are vested with power to impose sanctions on a party for the deliberate destruction of evidence.[47] These sanctions can include an adverse inference or the preclusion of evidence,[48] and such sanctions can be considered for purposes of summary judgment or trial.[49] A party can seek sanctions for document destruction where it can show that the destruction of documents occurred in bad faith and that it was prejudiced as a result.[50]

Receivers, however, may argue that they should not be responsible for any document destruction carried out by the Ponzi schemers before the receivership was created. Even if document destruction occurred on a massive scale, receivers may argue that *they* should not be punished or stymied in any future lawsuit they bring.

Fortunately, courts largely do not appear to have embraced this argument. To begin, while the argument may have some superficial appeal, it is contrary to the general rule that governs receivers, which is that they step into the shoes of the receivership entities, taking the bitter with the sweet.

Moreover, a receiver's attempt to escape the ordinary consequences of spoliation can be unfairly damaging for a defendant. It places a defendant at a general evidentiary disadvantage that the Federal Rules of Civil Procedure never envisioned. It can also have more sinister consequences. For example, once a Ponzi scheme is discovered, the Ponzi scheme masterminds may enter into plea agreements that require them to cooperate with the Ponzi scheme receiver. A receiver in a Ponzi scheme case thus may enjoy ready access to testimony from Ponzi schemers, a dubious source of information. This problem is exacerbated when the Ponzi scheme mastermind has also destroyed documents. Fraudsters can say absolutely anything without fear of contradiction because they have destroyed any contradictory evidence. Without the evidence—or a negative evidentiary inference—a defendant may be left with little means to defend against such testimony. Permitting a Ponzi scheme receiver to both rely on testimony from a fraudster (who has an incentive to cooperate) and sidestep the ordinary consequences of the fraudsters' document destruction creates inequities that the Federal Rules of Civil Procedure were carefully calibrated to avoid.

A defendant's best strategy in response is to persuade the court that receivers should not benefit from the prior bad conduct of their receivership entities. This is supported by the case law on receiverships in

---

[43] Id. at *3 (citation omitted); see also FDIC v. 26 Flamingo, LLC, 2013 WL 3975006, at *4 (D. Nev. Aug. 1, 2013) (The fact "the [FDIC] had no involvement with [the failed bank] before its failure does not, standing alone, relieve it of its obligations to designate a 30(b)(6) deponent.") (quoting FDIC v. Wachovia Ins. Servs., Inc., 2007 WL 2460685, at *2 (D. Conn. Aug. 27, 2007)).

[44] United Techs. Motor Sys., Inc. v. Borg-Warner Auto., Inc., 1998 WL 1796257, at *3 (E.D. Mich. Sept. 4, 1998); see also Gowan v. Mid Century Ins. Co., 2016 WL 126746, at *6 (D.S.D. Jan. 11, 2016) (a party duly served with a deposition notice cannot refuse to be deposed by saying "send me an interrogatory or deposition by written questions"); Richardson v. Sugg, 220 F.R.D. 343, 348 (E.D. Ark. 2004) (holding that "a party is free [to] choose its method of discovery," and requiring that deponent give oral testimony, notwithstanding deponent's preference to receive written questions).

[45] *Brudnicki*, 2013 WL 5814494, at *3. See also Empire Home Servs., L.L.C. v. Empire Iron Works, Inc., 2007 WL 1218717, at *12 (E.D. Mich. Apr. 23, 2007) ("The essence of live depositions is the opportunity to pursue lines of inquiry through a give and take that is impossible to achieve solely through written communication," and further, "depositions exist to test and verify the record evidence with sworn testimony.").

[46] Zubulake v. UBS Warburg LLC, 220 F.R.D. 212, 214 (S.D.N.Y. 2003).

[47] See, e.g., Stevenson v. Union Pac. R.R., 354 F.3d 739, 745 (8th Cir. 2004).

[48] Id. at 750.

[49] See, e.g., In re Oracle Corp. Sec. Litig., 627 F.3d 376 (9th Cir. 2010); In re NTL, Inc. Sec. Litig., 244 F.R.D. 179, 201 (S.D.N.Y. 2007), aff'd sub nom. Gordon Partners v. Blumenthal, 2007 WL 1518632 (S.D.N.Y 2007).

[50] Stevenson, 354 F.3d at 747–48.

other contexts. For example, courts have held that a receiver "stands in the shoes of the corporation or person whose property is in receivership, with exactly the same rights and obligations . . . as such person had at the inception of the receivership."[51] This means a receiver is "subject to liens, priorities, equities, privileges, claims, defenses and estoppels existing at the time of his appointment."[52]

In addition, courts have recognized that receivers cannot avoid other unfavorable consequences of actions take by the receivership entities—for example:

- Defendants have a right to assert counterclaims against a receiver that arose before the receiver was appointed;[53] and
- Receivers may not get out of the arbitration agreements that bind their receivership entities.[54]
- Receivers are subject to all defenses that a defendant had against the receivership entities prior to appointment of the receiver.[55]

In addition, defendants should point to a key rationale for imposing sanctions for document destruction: putting the prejudiced party back in the position it would have been in absent spoliation.[56] This rationale prioritizes rectifying the defendant's disadvantage.

Thus, while the receiver may bring a claim on behalf of the receivership entities,[57] courts should not permit it to *benefit* from their misconduct. A contrary rule is deeply unfair to defendants and damaging to the balance the judicial system strives to achieve. ■

[51] Shook v. United States, 26 Cl. Ct. 1477, 1485 n. 3 (1992) (citations omitted).

[52] 65 Am. Jur. 2d *Receivers* § 165, supra note 3; Kelley v. Coll. of St. Benedict, 901 F. Supp. 2d 1123, 1129 (D. Minn. 2012) ("[A] receiver is subject to all defenses to which the receivership entity is subject.").

[53] United States v. Mansion House Ctr., 767 F. Supp. 995 (E.D. Mo. 1991).

[54] Gross v. Weingarten, 217 F.3d 208 (4th Cir. 2000); *Wuliger*, 567 F.3d at 794.

[55] See, e.g., SEC v. Bilzerian, 378 F.3d 1100, 1108 (D.C. Cir. 2004); see also Polsky v. Virnich, 2006 WL 6192835 (Wis. Cir. Mar. 30, 2006) (receiver was subject to defenses because "receiver takes property subject to any existing defects and subject to any defenses that were available against the corporation").

[56] Kronisch v. United States, 150 F.3d 112, 126 (2d Cir. 1998) (noting the "prophylactic," "punitive," and "remedial" rationales for the adverse inference).

[57] See text supra, subsection titled "Evil Zombies: The *In Pari Delicto* Defense Applied to Receivers."

©

Authorized Reprint

JOURNAL OF
TAXATION and
REGULATION of
FINANCIAL INSTITUTIONS

Copyright © 2017 Civic Research Institute, Inc. This article is reproduced here with permission. All other reproduction or distribution, in print or electronically, is prohibited. All rights reserved. For more information, write Civic Research Institute, 4478 U.S. Route 27, P.O. Box 585, Kingston, NJ 08528 or call 609-683-4450. Web: http://www.civicresearchinstitute.com/tfi.html.