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May 2009

Reporter

Bankruptcy

by Peter A. Davidson, Esq.

Investing Safely After Madoff

Most of us did not get directly burned by the Madoff fraud. We are not Kevin Bacon or Steven Spielberg. We are not Palm Beach matrons. We didn't run multimillion dollar hedge funds or charities. But investment fraud doesn't always target the rich. Just the opposite. Small, less sophisticated investors are usually its victims.

How can you protect yourself from losing everything when you invest? There are a number of ways, some of which sound like clichés. But clichés are clichés because they tend to be true. For example: "Money doesn't grow on trees." Something to remember when you invest. Here are some pointers to help you invest safely.

1. **Don't put all your eggs in one basket.** In other words: "Diversify." This applies not only to what you invest in, but who you invest with. Many Madoff investors gave him their life savings. Now they have nothing. If something goes wrong or the sector you invested in takes a tumble (financials, real estate), the impact will be less severe if you have your investments spread around. A number of websites have simple tests you can take to see what your risk tolerance is and suggestions on the types of portfolios that might be right for you that will help you diversify. Google: "investment risk tolerance test."

2. **If it sounds too good to be true, it usually is.** Don't be fooled by promises of high returns at little or no risk. Promises of returns of 10, 20 or 50 percent per quarter (or with some scams per month) when other investments are paying 2 to 5 percent per year, should make alarm bells go off. Generally, the higher the return, the greater the risk. Be wary of claims that investments are "guaranteed" or "risk free." The only investments that are risk free are U.S. Treasuries or bank accounts insured by the government through the FDIC. And don't borrow to make an investment. I cringe when I hear about investors who borrow on their credit cards (at 19 percent!!) just to invest in some scam that was "too good to be true."

3. **Beauty is only skin deep.** Don't be fooled by glossy brochures, fancy websites or celebrity endorsements. Check out what's being promised. Review the company's financial statements. Make sure everything regarding an investment is in writing. Securities brokers and investment advisors have licenses. See if who you are dealing with does and whether they or their company have had problems with regulators or other investors. Websites abound with information that can be easily accessed. Besides a Google search, the SEC's website, www.sec.gov, has a wealth of information for investors about investment scams to avoid and how investors can check out brokers they are dealing with or investments they are considering. Other good sites include those maintained by the North American Securities Administrators Association, www.nasaa.org and www.investoreducation.org. Also check with your local Better Business Bureau to see if there is a history of complaints.

4. **Only fools rush in.** Don't be pressured into making an investment. Take your time to think and make sure

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the investment is right for you and your risk tolerance. Can you afford to lose the investment or suffer a thirty percent loss? Is the investment liquid if you need to cash out in an emergency? Be wary if you are told to keep the investment opportunity "confidential" or if you have to act "now."

5. **Look before you leap.** Understand what you are investing in, its business, products or services. While you don't need a working knowledge of every business you invest in, you should have a basic understanding of what the business does and how it makes money, so you can judge its risks, potential and if it is right for you. Avoid investments based on purported inside or confidential information, contacts or systems. If you didn't understand Madoff's "split-strike option conversion" trading strategy, it probably wasn't for you. Which, as it turned out, is a good thing.

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Clawbacks: Old Remedies – New Name

"Clawbacks." You may have heard the press use this term in the many stories about the Madoff, Stanford and other recent Ponzi schemes. What is a "clawback"? It sounds ferocious, animalistic, which is probably why the press uses the term and, in fact, invented it to describe legal remedies that have long existed.

Clawbacks describe two remedies that receivers or bankruptcy trustees can use to recover transfers made by an entity or person in receivership or bankruptcy – fraudulent transfers or preferences.

A fraudulent transfer is a transfer made "with the actual intent to hinder, delay, or defraud a creditor" or a transfer made while the transferor is "insolvent" and for "less than a reasonably equivalent value." Fraudulent transfers occur in Ponzi schemes whenever the operator of the scheme pays an investor because a Ponzi scheme by definition is fraudulent. The operator knows it cannot go on forever and that later investors will not be paid. Ponzi schemes are also insolvent from inception because the scheme never has sufficient funds to pay the promised returns. State law and the Bankruptcy Code authorize lawsuits to recover fraudulent transfers so that the payments can be redistributed to all victims of the scheme equally.

What this means is that Madoff or similar investors who received payments from the scheme may be forced to return them, even though they did nothing wrong. While this may seem unfair, courts have reasoned that because the payments did not come from actual earnings, but from other, later, investors' money, it is no different from receiving stolen property, which must be returned. As one court put it: "he should not be permitted to benefit from a fraud…merely because he was not himself to blame for the fraud."

This is nothing new, however. Fraudulent transfer statutes have existed since the late 1500's. The press has simply given them a new catchy name. The same is true with "preferences," which also have been included in the term clawbacks. Preferences only occur in bankruptcy cases. The concept developed as an offshoot of fraudulent transfers and has existed in American bankruptcy law since 1841. A bankruptcy trustee is authorized to recover payments made within ninety days of the filing of a bankruptcy (one year if the recipient was an "insider") on a debt made while the transferor was insolvent and which resulted in the recipient receiving more than he or she would have as a creditor in the bankruptcy. The object, like with fraudulent transfers, is to treat creditors equally. Because, by definition, a Ponzi scheme is insolvent from the beginning, virtually all transfers made to investors within ninety days of the bankruptcy will be recoverable. While there are defenses to preference claims, the most used — that the payment was made in the "ordinary course of business" — is not permitted where a Ponzi scheme is involved because courts have held that such schemes are not legitimate businesses, they are frauds.

The upshot is that investors in these schemes who got out early, often with a profit, may have a rude awakening when some snarling receiver or bankruptcy trustee appears to "clawback" the payments using these long-existing remedies. As Dorothy might exclaim, "Lions and tigers and receivers, oh my!"

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