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Clawback Claims Against Innocent Investors: The SEC vs. the Stanford Receiver

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The case of the *Securities and Exchange Commission v. Stanford International Bank Ltd., et al.*, took an interesting turn in July 2009 when the Securities and Exchange Commission (SEC) took the extraordinary step of seeking to have the federal court limit the receiver's authority to file avoidance (clawback) claims against innocent investors. After a round of sometimes strongly-worded briefings and a hearing on July 31, 2009, the court denied the SEC's request. This controversy illustrates the differences between how the SEC views its responsibility to the investing public and how the Stanford receiver views his responsibility to the court and the Stanford estate.

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Ralph S. Janvey, the receiver in the Stanford International Group and related cases, was appointed by the court at the SEC's request, and his duties and authority derive from the court order that appointed him. The receiver now finds himself at odds with the SEC. In the Report of the Receiver, dated April 23, 2009, Mr. Janvey reported to the court that he was considering filing clawback claims against certain Stanford investors who had redeemed certificates of deposit (CDs) issued by Stanford International Bank Limited within the year prior to the commencement of the receivership. Such claims were to extend both to any interest paid on the CDs and the principal amounts of the investments in the CDs. Mr. Janvey estimated that such claims could exceed $300 million and did not propose limiting his claims to those investors who had committed some sort of wrongdoing. Following the filing of his report, Mr. Janvey filed several clawback claims against innocent investors for the return of both principal and interest.

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In response to Mr. Janvey's report and the subsequent filing of clawback claims against innocent investors, the SEC filed its Emergency Motion to Modify Receivership Order. The SEC stated that it only filed the motion "[a]fter great consideration." Indeed, the SEC's motion exudes reluctance at having to attempt to rein in a receiver appointed at the SEC's request. Nonetheless, the SEC sought to reduce Mr. Janvey's authority because it found that Mr. Janvey's actions in pursuing clawback claims against innocent investors "contravenes Commission practice and is supported by neither logic nor the law."

In addition to the SEC, the court-appointed examiner, John J. Little, also took issue with the proposed clawback claims. Mr. Little was appointed by the court to assist in considering the interests of Stanford investors. In his Examiner's Report and Recommendation No. 1, Mr. Little noted that the investors targeted by Mr. Janvey were innocent of wrongdoing and that the proposed claims were being filed only against those investors who had assets frozen by court order at Pershing LLC, a securities broker. Mr. Little stated that he believed that it was inappropriate for Mr. Janvey to target only those investors who had assets frozen at Pershing, characterizing such investors as "low-hanging fruit." Indeed, the claims that Mr. Janvey has brought to date are all against investors who have assets frozen at Pershing.

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The SEC's rationale for asking the court to limit Mr. Janvey's authority to bring these clawback claims is twofold. First, it argues that it is against SEC policy to bring these types of claims against wholly-innocent investors for return of the principal amount invested, as opposed to profit or interest on such investment. Second, the SEC argues that these types of claims are not supported in the law.

The SEC's policy argument in support of its position that Mr. Janvey should not bring claims against innocent investors for the return of principal is based on its status as the watchdog governmental agency tasked with

protecting securities investors. It does not want to be seen as being a party to actions that cause hardship to investors who have done nothing wrong. Here, the SEC makes a hard-line distinction between the recovery of principal investments and the recovery of interest. It has long been the practice of the SEC and its receivers appointed in cases commenced by the SEC to go after so-called Ponzi payments—profits or interest paid to investors in a Ponzi scheme—on the theory that such amounts are rightfully the property of later investors in the scheme. Investors who merely recovered their principal from a Ponzi scheme, however, have generally not been the target of such suits. The reasoning is simple: Forcing innocent investors to return funds they contributed to the defunct entity does nothing more than create new victims of the fraud because it deprives those investors of their actual out-of-pocket contributions.

Mr. Janvey argues in response that he does not work for the SEC, but instead works for the court that appointed him. He believes that the court authorized him to bring such actions as he sees fit for the benefit of the Stanford estate and that actions against investors, even innocent investors, for return of principal are within that authority. He also argues that the clawback claims are being brought based on "fundamental fairness and equity." The vast majority of the Stanford investors did not redeem their CDs and are faced with the prospect of receiving pennies on the dollar for their investments. Mr. Janvey argues that the funds received by innocent investors who redeemed before the receivership was filed are actually the stolen funds of later investors (a position that seems factually correct). According to Mr. Janvey, the failure to file clawback claims against these innocent investors would unfairly prefer those investors who were lucky enough to redeem their investments before the fraud was discovered. In other words, Mr. Janvey believes that all investors, even those investors who redeemed their investments before the receivership was filed, should share equally in the losses.

There is an underlying current to these arguments that pertains to the type of investors Mr. Janvey has chosen to target. Specifically, he has chosen to target only those investors (around 650) who have assets frozen at Pershing. The potential principal and interest claims against these investors total approximately $300 million. According to Mr. Little, there are more than 28,000 total Stanford investors. More than 20,000 of these investors are beyond the jurisdiction of the U.S. courts.

Between January 2008 and the inception of the receivership in February 2009, approximately $2 billion was paid out in Stanford CD redemptions. Accordingly, Mr. Janvey proposes to file claims against only 650 of 28,000 Stanford investors and to seek recovery of only $300 million out of a possible $2 billion in CD redemptions. The investors who have been targeted have been solely because they have assets frozen at Pershing. This is the case even though the assets that are frozen are not necessarily the proceeds of the redeemed CDs.

[T]here are good policy reasons for allowing a receiver to claw back Ponzi payments (profits and interest) from even wholly innocent investors. What is not clear is whether there are any good policy reasons for allowing a receiver to recover principal investments from wholly innocent investors. The SEC, the agency tasked with protecting investors, certainly thinks that there are no such good policy reasons, and that position should carry a certain amount of force.

The argument of the SEC and Mr. Little that Mr. Janvey is going after "low hanging fruit" seems to have merit. While there were more than $2 billion in CD redemptions in the year before the receivership action was filed, Mr. Janvey only proposes to file claims against those investors who have assets frozen at Pershing. Since those investors have assets frozen at Pershing, the claims by Mr. Janvey are easily collectible should he prevail on the merits. More importantly, it gives Mr. Janvey additional leverage in attempting to force a settlement on these unlucky investors.

Apart from the issue of the frozen accounts is the issue of the court's jurisdiction. Mr. Janvey is pursuing clawback claims against these 650 investors because he can obtain jurisdiction over them by virtue of the frozen accounts and for some, by virtue of their location in the United States. However, the vast majority of the investors who will benefit from these clawbacks if they are successful are persons and entities who are not U.S. residents and are not subject to the court's jurisdiction. If equity is the receiver's ultimate goal, this seems like a fairly inequitable result.

The SEC's second argument is that the claims of the receiver relating to principal lack merit, will therefore be unsuccessful, and are thus likely to result in a net loss to the estate. The substantial legal fees generated by pursuing such claims will not be recovered. The SEC argues that there is no support in the law for a receiver to pursue successfully wholly-innocent investors for the return of principal. In response, Mr. Janvey argues that there would not be many examples of a receiver bringing clawback claims against innocent investors because it is contrary to SEC policy to bring such claims. He points out that there are cases in which receivers have brought clawback claims against innocent investors and there are cases in which receivers have successfully recovered an investor's principal investment. What is absent, however, are cases in which a receiver has clawed back the principal investment from an innocent investor.

There are good policy reasons for allowing a receiver to recover the principal investment from someone who was implicated in the fraudulent activities. Likewise, there are good policy reasons for allowing a receiver to claw back Ponzi payments (profits and interest) from even wholly innocent investors. What is not clear is whether there are any good policy reasons for allowing a receiver to recover principal investments from wholly innocent investors. The SEC, the agency tasked with protecting investors, certainly thinks that there are no such good policy reasons, and that position should carry a certain amount of force.

One troubling aspect of the claims being brought by Mr. Janvey is the prospect that they could end up being net losers for the estate. If the SEC and the examiner are correct that the claims against innocent investors for the return of principal are without legal merit, the estate stands to expend a substantial

amount of resources with little prospect for a meaningful recovery. According to Mr. Little, the amount of interest paid to these 650 investors would likely be less than the amount spent by Mr. Janvey in pursuing these claims. Such an outcome would be devastating for an estate that has already been largely exhausted by the legal and other professional fees incurred by the receiver.

The court may have found a middle ground in ruling on these issues. It denied the SEC's motion to limit the authority of the receiver. However, the court also ordered that the freeze be terminated for assets held by innocent investors at Pershing other than amounts of interest received by those investors, but agreed to stay that decision to allow the receiver to appeal the ruling to the Fifth Circuit Court of Appeals.

Presuming that the court's ruling is upheld, the receiver would still be able to pursue the clawback claims against innocent investors, including claims for recovery of principal, but would relieve these investors of the hardship of having their assets held indefinitely under an asset freeze. Of course, the court's ruling may also have the effect of preventing Mr. Janvey from collecting on his judgments should he ultimately be successful on his claim for the return of principal. However, the risk that a judgment is uncollectible is a risk that every plaintiff faces, and it does not justify Mr. Janvey's request that all the assets of the innocent investors be held for possible collection absent some additional showing justifying that extraordinary relief.

The SEC, as the plaintiff in the Stanford case, argues that it deserves a "high degree of deference in shaping the case and the type of relief sought." The SEC is the agency that investigates securities fraud and in certain cases, asks for the appointment of a receiver to protect investors, marshal assets and ultimately return those assets to the defrauded investors. The SEC could do these tasks on its own, but has found that the appointment of a receiver in many cases is the most cost-effective way to perform these tasks since the SEC's resources are finite. It seems that a receiver, when performing his or her duties, should owe some degree of deference to the SEC's established policies.

Although receivers are court-appointed and their duties and powers arise from the court order appointing them, they are also creatures of the SEC designed to carry out tasks that the SEC supports. The court orders appointing SEC receivers are generally broad and allow the receiver much discretion in carrying out his or her duties. It would be unfortunate if the result of the conflict between the SEC and the Stanford receiver were to be restrictions placed in appointment orders of SEC receivers.

The appointment of receivers in SEC cases is a process that has worked well over the years. Receivers take over the task from the SEC of recovering assets for investors who have been defrauded and returning those assets to the defrauded investors, allowing the SEC to move on to the next case. If the SEC concluded that the broad authority now typically granted to a receiver would thwart SEC policies, it might feel compelled to ask the courts to grant more limited authority. That would put more of a burden on the SEC, which would use up valuable resources that could be expended elsewhere. Perhaps the dispute between the Stanford receiver and the SEC is merely an aberration borne out of an understandable desire of this receiver to maximize the recovery of these victims of one of the largest frauds in history in a situation where the assets of the estate are small in comparison to the claims.

Some guidance may be taken from the Bernard Madoff case, another astronomical Ponzi scheme. In that case, a trustee was appointed at the behest of the Securities Investor Protection Corporation. The Madoff trustee, Irving H. Picard, issued guidelines for when he might pursue claims against innocent investors for fraudulent transfers. Those guidelines included (1) whether the customer was a net "winner" or "loser" with respect to his investment, (2) whether the avoidance action would create an undue hardship for the customer and (3) whether there are facts and circumstances such as a lack of good faith on the part of the customer. Perhaps a more nuanced approach like that taken by the Madoff trustee would have allowed the SEC to accept the Stanford receiver's evaluation of avoidance suits against customers. This is an approach that future SEC receivers may consider. ■

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