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ALERT - 5th Circuit Ruling on Stanford Receiver's Clawback Claims

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On November 13, 2009, the Court of Appeals for the Fifth Circuit ruled in the Stanford securities fraud case that the appointed receiver lacked authority to "claw back" principal and interest proceeds distributed to innocent investors/creditors because they have a legitimate ownership interest in the proceeds held in the accounts. This precedent has important implications for this and other ongoing "Ponzi" scheme cases.

The Stanford Case: Alleged Multi-Billion Dollar Ponzi Scheme
The Stanford proceedings began after the Securities and Exchange Commission (SEC) filed a securities fraud action against Stanford International Bank, Ltd. and related companies on February 16, 2009 for an alleged multi-billion dollar Ponzi scheme. The SEC contends that the Stanford companies sold certificates of deposit issued to innocent investors by "promising above-market returns and falsely assuring investors that the CDs were backed by safe, liquid investments." In true Ponzi-fashion, it alleges the proceeds of new CD sales were applied to payments on previous CDs because the issuers lacked the actual funds to cover the liabilities it had already incurred.

The Clawback Action: Principal vs. Interest
The district court appointed a receiver and issued an injunction freezing investment accounts at various investment firms. The receiver reviewed most of the accounts and released those that did not contain proceeds from Stanford CDs. The freeze on the remaining accounts was to expire August 3, 2009 unless the receiver asserted claims against the account owners. Before the expiration of the freeze, the receiver filed so-called "clawback" actions to continue the freeze on the accounts so as to allow the receiver to recover the funds for the receivership estate. The receiver named the account owners as relief defendants, but did not allege any wrongdoing on their part. The district court denied the receiver's claim with respect to the principal they had invested, but granted the receiver's claim with respect to the interest they earned. Both parties appealed.

The Appeal: "Relief Defendants"
The Fifth Circuit found the case turned upon the nature of a relief defendant. A relief defendant is a "nominal defendant [who] has no ownership interest in the property that is the subject of litigation but may be joined in the lawsuit to aid the recovery of relief." If the relief defendant "(1) has received ill-gotten funds, and (2) does not have a

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legitimate claim to those funds," that relief defendant may be subject to equitable disgorgement of the ill-gotten funds. The Court of Appeals found that the funds were ill-gotten, but ruled that the debtor-creditor relationship established by the written CD agreements between customers and the Stanford Bank "constitutes a sufficient legitimate ownership interest to preclude treating the [investors] as relief defendants." The court also noted that the purported relief defendants in this case are "a far cry from" traditional nominal defendants like trustees, agents or depositories. Therefore, the Fifth Circuit held the receiver's claims should have been denied with respect to both the principal and interest.

Clarity For Future Clawback Actions?

This precedent may prove highly persuasive in establishing the ground rules by which receivers must play in "clawback" actions in other Ponzi scheme or fraud cases. The Fifth Circuit's opinion provides authority on which innocent parties who claim a legitimate interest in otherwise ill-gotten funds may rely to protect their interests in those funds. The confirmation of the two-part test in this context should provide clarity in an otherwise murky world of receivership "clawback" actions.

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