

## Failing to Learn the Lessons of Madoff: Problems with Applying Iqbal to Fraud Claims

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# **Failing to Learn the Lessons of Madoff: Problems with Applying *Iqbal* to Fraud Claims**

Howard Gutman and Chris Garino

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## **ABSTRACT**

The *Iqbal* standard requires all civil actions filed in federal courts to provide detailed proof at the pleading stage for the claim to proceed. Under this standard, cases are adjudicated without the aid of discovery or deposition of witnesses. Cases are decided at the pleading stage based on the documents and statements provided by the one accused of fraud. The tools to uncover deception are not available at this stage. This article argues that the *Iqbal* pleading standard fails to allow civil courts to adequately detect and adjudicate fraud claims.

This article explores fraudulent financial schemes, the *Iqbal* standard, the standard of plausibility, and the requirement of proof at the pleading stage. This article then analyzes the problems presented by *Iqbal* when applied to cases of financial fraud. Finally, this article discusses how, rather than learning from the mistakes of the SEC in the Madoff investigation, our civil court system created a framework for adjudication of fraud cases that generates the same risk for miscalculation as was present during the Madoff investigation. This risk for miscalculation is still present because of the courts' typical process of accepting the words of those accused of fraud, rewarding the falsification of records, misplacing its assessment of credibility, and making determinations based on limited records. Given the problems associated with adjudicating fraud claims under the *Iqbal* standard, a review of the *Iqbal* standard is essential to provide victims of fraud with proper recourse and justice.

## **AUTHORS NOTE**

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This article would not have been possible without the truth-seekers. Harry Markopoulos' reports to the SEC and memoir, *No One Would Listen: A True Financial Thriller*, laid the groundwork for our research while providing an example of the plausibility issues plaintiffs often face. Moreover, the authors would like to acknowledge the survivors of Madoff's scheme and of financial fraud worldwide. We hope that this article will lay the groundwork for a system that prioritizes justice over convenience.

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## INTRODUCTION

Bernie Madoff perpetrated the largest Ponzi scheme in history. It spanned two decades and involved thousands of fraudulent transactions and over sixty billion dollars in diverted funds.<sup>1</sup> Corporate officers, lawyers, and wealthy individuals received monthly statements and purported transactions,<sup>2</sup> but the scheme went undetected for over fifteen years.<sup>3</sup> When asked to duplicate the impressive results, an astute competitor became convinced the Madoff program was a Ponzi scheme and presented several complaints to the Securities Exchange Commission (SEC).<sup>4</sup> The reports noted various characteristics of a Ponzi scheme, such as unusually high and consistent results despite market fluctuations, lack of transparency, and secrecy.<sup>5</sup>

The SEC, charged with investigating securities violations and uncovering fraud,<sup>6</sup> received these complaints, examined the Madoff program, reviewed client files and records from multiple transactions,

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<sup>1</sup> Scott Cohn & Marty Steinberg, *Bernie Madoff, mastermind of the nation's biggest investment fraud, dies at 82*, CNBC, <https://www.cnbc.com/2021/04/14/bernie-madoff-dies-mastermind-of-the-nations-biggest-investment-fraud-was-82.html> [<https://perma.cc/V9C9-N36E>] (last updated Apr. 14, 2021, 4:37 PM); Lionel Lewis, *Madoff's Victims and Their Day in Court*, 47 Soc'y 439, 439 (2010) (indicating that, "over 40 countries, 339 funds of funds, and 59 asset management companies were invested with [Madoff].").

<sup>2</sup> *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122, 128-29 (Bankr. S.D.N.Y. 2010) [hereinafter *In re Bernard L. Madoff Inv. Sec. LLC*].

<sup>3</sup> Cohn, *supra* note 3.

<sup>4</sup> HARRY MARKOPOLOS, *NO ONE WOULD LISTEN: A TRUE FINANCIAL THRILLER* 7 (John Wiley & Sons, Inc. 2009). Harry Markopolos, the astute competitor, found that the high volume of returns indicated either front-running or a Ponzi scheme. *Id.*

<sup>5</sup> U.S. SEC. & EXCH. COMM'N, *OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME* 238 (2009) [hereinafter *SEC REPORT NO. OIG-509*], available at <http://www.sec.gov/news/studies/2009/oig-509.pdf> [<https://perma.cc/QF5V-4KTX>]. Reports from Markopolos alleged, "30 red flags indicating that Madoff was operating a Ponzi scheme, a scenario described as 'highly likely.' The red flags included the impossibility of Madoff's returns, particularly the consistency of those returns and the unrealistic volume of options Madoff represented to have traded." *Id.* at 21.

<sup>6</sup> *Mission*, SEC. & EXCH. COMM'N, <https://www.sec.gov/about/mission> [<https://perma.cc/TK73-7Q3B>] (last updated Aug. 29, 2023).

and even interviewed Madoff.<sup>7</sup> However, the SEC found no evidence of a Ponzi scheme, only minor technical violations.<sup>8</sup> Therefore, Madoff's scheme carried on, whereby he continued soliciting billions of dollars and ensnaring more and more victims.<sup>9</sup>

Madoff's scheme, however, would come to a halt following the 2008 financial crisis and the failures of several securities firms.<sup>10</sup> As a result, Madoff's investors sought to liquidate their assets and convert their ostensibly large gains into cash.<sup>11</sup> However, with present and expected redemptions far above existing assets, Madoff was compelled to reveal his long-standing fraud.<sup>12</sup> The results were devastating; families found their accumulated investments were illusory, and older persons, in particular, found themselves without the funds needed for retirement.<sup>13</sup> Frantic calls and visits to Madoff's offices went

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<sup>7</sup> See generally SEC REPORT NO. OIG-509, *supra* note 7.

<sup>8</sup> Alex Berenson & Diana Henriques, *Look at Wall St. Wizard Finds Magic Had Skeptics*, N.Y. TIMES (Dec. 12, 2008), <https://www.nytimes.com/2008/12/13/business/13fraud.html> [<https://perma.cc/Y8EF-MN86>].

<sup>9</sup> JIM CAMPBELL, *MADOFF TALKS: UNCOVERING THE UNTOLD STORY BEHIND THE MOST NOTORIOUS PONZI SCHEME IN HISTORY* 245-47 (McGraw Hill 2021). Many personal expenses were billed to or paid for by the company; for example, in the month of February for 2008 "Ruth had charges of \$58,000; Peter Madoff: \$20,000; Mark Madoff: \$11,000; Andrew Madoff: \$8,000 . . . . Ironically, the ostensible cardholder, Bernie Madoff's charges for the month: \$0"). *Id.* at 246.

<sup>10</sup> *Bernie Madoff's Ponzi Scheme (2008)*, INT'L BANKER (Sept. 29, 2021), <https://internationalbanker.com/history-of-financial-crises/bernie-madoffs-ponzi-scheme-2008> [<https://perma.cc/D4RE-SY72>]. Multiple banks and large corporations failed, or required massive assistance, as the stock market suffered record-breaking losses; several well-known and seemingly reliable stalwarts failed, which lead to the near collapse of the financial system and Madoff's scheme. ANDREW SORKIN, *TOO BIG TO FAIL 3* (Penguin Books 2009).

<sup>11</sup> Kaitlin Menza, *How Bernie Madoff Took His Family Down*, TOWN & COUNTRY (Apr. 14, 2021), <https://www.townandcountrymag.com/society/money-and-power/a9656715/bernie-madoff-ponzi-scheme-scandal-story-and-aftermath> [<https://perma.cc/A38R-WUQK>]; see also Diana B. Henriques & Zachery Kouwe, *Billions Withdrawn Before Madoff Arrest*, N.Y. TIMES (May 12, 2009), <https://www.nytimes.com/2009/05/13/business/13madoff.html> [<https://perma.cc/MT76-7A4V>].

<sup>12</sup> *Bernie Madoff's Ponzi Scheme (2008)*, *supra* note 12. As the scandal reached a crescendo in December 2008, Madoff confessed the scheme to his two sons who turned him in to the FBI. *Id.*

<sup>13</sup> See Muralikumar Anantharaman, *Two U.S. pension funds see \$52 mln hit from Madoff*, REUTERS (Dec. 15, 2008), <https://www.reuters.com/article/madoff-pension/two-u-s-pension-funds-see-52-mln-hit-from-madoff-idUSN155227920081216> [<https://perma.cc/NL44-ADFC>].

unanswered, and visitors found FBI agents conducting a raid that would result in Madoff's lifetime imprisonment.<sup>14</sup>

Initially, investigators questioned Madoff's strained explanations for his success, but Madoff used his prominence as the former chairman of NASDAQ to dismiss suspicion.<sup>15</sup> His stories and tales led investigators to approach the complainant with skepticism.<sup>16</sup> After Madoff revealed his fraud, critics pointed fingers at many for this failure to investigate, but perhaps most at the SEC. A large-scale fraud had escaped regulatory scrutiny for years, and even in the face of multiple complaints identifying the fraud, little had been done. Worst of all, the investigation and purported audit had essentially cleared Madoff, leading many hapless investors to provide more money to the fraudulent scheme.<sup>17</sup>

The SEC's failure to recognize Madoff's scheme highlights a key obstacle for victims seeking justice through civil fraud claims: those engaged in fraud are not above deceiving regulators and the courts. Two cases decided in the last sixteen years, *Bell Atlantic Corp. v. Twombly*<sup>18</sup> and *Ashcroft v. Iqbal*<sup>19</sup> (collectively, *Iqbal*), govern the pleading standard of most civil cases in federal court, including fraud.<sup>20</sup> Before *Iqbal*, a court would deny a motion to dismiss if the complaint set forth

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<sup>14</sup> See *Exclusive: Bernie Madoff's Secret Plan to Destroy the Ponzi Evidence*, ABC NEWS (Feb. 4, 2016, 7:14 AM), <https://abcnews.go.com/US/exclusive-bernie-madoffs-secret-plan-destroy-ponzi-evidence/story?id=36578325> [<https://perma.cc/27RG-Z5G6>]; see also Henriques, *supra* note 13.

<sup>15</sup> See CAMPBELL, *supra* note 11, at 106. Upon admitting \$7 billion in handled funds to reporter Mike Ocran in 2001, Madoff accidentally admitted that his returns could not possibly be accurate as they were, "bigger than the market" itself; however, when pressed on this admission, Madoff replied, "You got to give me credit. I designed NASDAQ. I'm not going to do business on the floor of the exchange where I can be reverse engineered . . ." *Id.* at 121.

<sup>16</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 368.

<sup>17</sup> *Id.*

<sup>18</sup> *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 548 (2007).

<sup>19</sup> *Ashcroft v. Iqbal*, 556 U.S. 662, 666 (2009). This case involved claims against federal law enforcement actors by migrants of Middle Eastern descent who alleged discriminatory policing and imprisonment policies for Islamic prisoners after the September 11 attacks. *Id.* at 666-69. The Court ultimately held that *Iqbal* did not lodge a plausible complaint against Ashcroft or Mueller, the then-director of the FBI. *Id.* at 680. The *Iqbal* pleading standard is now the current standard used to dismiss claims from plaintiffs who cannot state a claim of plausible fact.

<sup>20</sup> See *Ashcroft v. Iqbal: The New Federal Pleading Standard*, JONES DAY (June 2009), <https://www.jonesday.com/en/insights/2009/06/iashcroft-v-iqbali-the-new-federal-pleading-standard> [<https://perma.cc/PYS4-CJMQ>].

a cause of action.<sup>21</sup> The assessment of the validity of the claim would be a task for discovery and, if need be, trial.<sup>22</sup> *Iqbal* changed this standard in federal court. Under *Iqbal*, to defeat a motion to dismiss, the plaintiff must establish that the elements of a cause of action are not only adequately pled but substantiated through competent proof. Otherwise, except in limited circumstances, discovery or other inquiry will not be permitted.<sup>23</sup>

Under *Iqbal*, many fraud claims never make it to trial, where the truth can be revealed through discovery, deposition of witnesses, and examination of outside documents.<sup>24</sup> Instead, the complaint's sufficiency is based upon affidavits and briefs submitted by the plaintiff with the limited facts or documents they possess, along with any material presented by the party accused of deception.<sup>25</sup> However, a decision based only on these affidavits proceeds with the assumption that the materials offered by the party charged with fraud will be reliable and truthful.<sup>26</sup>

This current law is flawed because we have failed to learn the lessons of Madoff. In adjudicating fraud claims on a limited record, courts are prone to make the same mistakes as the SEC did in clearing Madoff: over-reliance upon the word of the culprit, lack of record verification, outright fabrication, and unfair burdens upon a complainant

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<sup>21</sup> FED. R. CIV. P. 12(b)(6). Civil claims do not survive past the initial pleading stage if a plaintiff is unable to show an articulable harm by a specific actor. *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> See Benjamin Spencer, *Pleading Conditions of the Mind Under Rule 9(b): Repairing the Damage Wrought by Iqbal*, 41 CARDOZA L. REV. 1016, 1020 (2019) (“[T]he consequences of this view of Rule 9(b) have reverberated throughout the lower courts, facilitating the dismissal of a countless number of claims involving condition-of-mind allegations.”); see also Jason N. Haycock, *Pleading a Loss Cause: Resolving the Pleading Standard for the Element of Loss Causation in a Private Securities Fraud Claim and a Plaintiff’s Heavy Burden Pleading It Under Iqbal*, 60 AM. UNIV. L. REV. 173, 211 (2010). The *Iqbal* standard creates a “substantial burden for the plaintiff to carry at the pleadings stage . . . . The cumulative effect is that there will likely be many cases where a plaintiff had a meritorious, detailed, but not clear-cut private securities fraud claim, will ultimately find himself pleading a lost cause.” *Id.*

<sup>25</sup> Charles E. Clark, *Special Pleading in the “Big Case”*, 21 F.R.D. 45 app. at 53 (1957); see also *Lockett v. Rent-A-Center, Inc.*, 53 F.3d 871, 873 (7th Cir. 1995) (warning that “the pleading stage is not the occasion for technicalities”).

<sup>26</sup> *Everything You Need To Know About Affidavits*, COURTROOM5, <https://courtroom5.com/blog/everything-you-need-to-know-about-affidavits/> [<https://perma.cc/DT78-8UB5>] (last visited Oct. 22, 2024).



who typically lacks access to critical material regarding the fraud. Part of the problem is a “default to truth,” where we assume people are telling the truth and the documents they provide are genuine.<sup>27</sup> Ultimately, *Iqbal* requires detailed proof at the pleading stage for the claim to proceed, and in most cases, precludes discovery, a potent tool for uncovering the truth.<sup>28</sup> Preventing a plaintiff from investigating the source of his injury stifles the purpose of our justice system and provides the fraudster with an escape hatch for his misconduct.

By failing to learn the lessons from Madoff, fraudulent financial schemes continue to pose the same problems.<sup>29</sup> In fact, a little over a decade after Madoff’s scheme, a similar fraudulent scheme was conducted. A company called FTX proposed to provide secure access to funds in a new currency called crypto, with amounts held in separate individual accounts, accessed by a secure key, and funds verified by impartial third parties.<sup>30</sup> However, these assurances were false, and FTX was leveraging customer assets for its own bets.<sup>31</sup> FTX’s victims would face the same issues as Madoff’s victims under the *Iqbal* standard. The problem of financial fraud will always be present, and courts should review the current pleading standard for fraud to give victims proper recourse.

This article explores how the *Iqbal* standard frustrates early detection of fraud and hampers adjudication by denying parties, and

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<sup>27</sup> CAMPBELL, *supra* note 11, at 92.

<sup>28</sup> FED. R. CIV. P. 26-37.

<sup>29</sup> *New FTC Data Show Consumers Reported Losing Nearly \$8.8 Billion to Scams in 2022*, FED. TRADE COMM’N (Feb. 23, 2023), <https://www.ftc.gov/news-events/news/press-releases/2023/02/new-ftc-data-show-consumers-reported-losing-nearly-88-billion-scams-2022> [<https://perma.cc/P87G-9X76>]. In 2022, the Federal Trade Commission (FTC) calculated a total of \$8.8 billion of consumer funds lost due to fraud. *Id.*

<sup>30</sup> Rohan Goswami & MacKenzie Sigalos, *How Sam Bankman-Fried swindled \$8 billion in customer money, according to federal prosecutors*, CNBC, <https://www.cnbc.com/2022/12/18/how-sam-bankman-fried-ran-8-billion-fraud-government-prosecutors.html> [<https://perma.cc/GZR6-7DG8>] (last updated Dec. 19, 2022, 2:06 PM); *see also* Timothy Smith, *FTX: An Overview of the Exchange and Its Collapse*, INVESTOPEDIA, <https://www.investopedia.com/ftx-exchange-5200842> [<https://perma.cc/25FD-6N5Y>] (last updated Jan. 5, 2023).

<sup>31</sup> Goswami, *supra* note 32; *see also* Scott Zamost et al., *Cryptocurrency investor says he saw serious ‘red flags’ with FTX founder Sam Bankman-Fried*, CNBC, <https://www.cnbc.com/2022/11/17/crypto-investor-saw-serious-red-flags-with-ftx-founder-sam-bankman-fried.html> [<https://perma.cc/PJ5L-GHDY>] (last updated Nov. 17, 2022, 3:22 PM).

ultimately the courts, the tools to detect deception. Section One examines the Madoff fraud and the SEC's subsequent investigation to illustrate the challenges presented by fraudulent financial schemes. Section Two discusses the *Iqbal* standard, the standard of plausibility, and the requirement of proof at the pleading stage. Section Three analyzes the problems presented by *Iqbal* when applied to financial fraud cases.

## I. ILLUSTRATIVE PROBLEMS WITH THE MADOFF INVESTIGATION

### A. Scope of Madoff's Fraudulent Scheme

In perpetrating his sixty-billion-dollar fraud, Madoff defrauded individual investors in the U.S. and various hedge funds, mutual funds, and investors throughout the world.<sup>32</sup> As the former Chairman of the Nasdaq Stock Exchange, Madoff enjoyed a reputation as a financial expert capable of delivering value that was “bigger than the market itself.”<sup>33</sup> His fraudulent scheme relied upon his in-depth knowledge of the securities market and human behavior.<sup>34</sup>

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<sup>32</sup> *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 124 (Bankr. S.D.N.Y. 2010) “[c]ustomers are purportedly owed a total of 64.8 billion.”; see also *Madoff – A 21<sup>st</sup> Century Ponzi Scheme*, NASAA, <https://www.nasaa.org/4303/madoff-a-21st-century-ponzi-scheme/> [<https://perma.cc/6CZ7-AY3P>] (last visited Oct. 16, 2023) (“Bernard Madoff perpetrated a multi-billion-dollar scam that defrauded investors around the world for decades until his arrest in December 2008.”).

<sup>33</sup> CAMPBELL, *supra* note 11, at 121.

<sup>34</sup> As Madoff confessed:

The essence of my scheme was that I represented to clients and prospective clients who wished to open investment advisory and individual trading accounts with me that I would invest their money in shares of common stock, options, and other securities of large well-known corporations, and upon request, would return to them their profits and principal. Those representations were false for many years . . . Those funds were deposited in a bank account at Chase Manhattan Bank. When clients wished to receive the profits, they believed they had earned with me or to redeem their principal, I used the money in the Chase Manhattan bank account that belonged to them or other clients to pay the requested funds.

Transcript of Plea Proceeding at 24, *United States v. Madoff*, No 09 CR 213 (S.D.N.Y. Mar. 12, 2009), available at <http://www.justice.gov/usao/nys/madoff/madoffhearing031209.pdf>.

Investors received monthly statements from Madoff detailing their investments in a diversified portfolio with exchange-listed stocks; however, these statements were false.<sup>35</sup> Trades, along with other transactions listed in various documents, were made to give the appearance of credibility.<sup>36</sup> Madoff created a separate department at his company where a select group generated these fraudulent transactions.<sup>37</sup> Programmers developed data entry programs capable of manufacturing fictional trades and other materials,<sup>38</sup> and then a small group of cohorts was charged with backdating these fictional trades, along with others tasked with creating the false statements.<sup>39</sup>

In his confession, Madoff described what investors were told:

I promised that I would select a basket of stocks that would closely mimic the price movements of the Standard & Poor's 100 index . . . I would opportunistically time those purchases and would be out of the market intermittently, investing client funds during these periods in United States Government-issued securities, such as United States Treasury bills. In addition, I promised that as part of the split strike conversion strategy, I would hedge the investments I made in the basket of common stocks by using client funds to buy and sell option contracts related to those stocks, thereby limiting potential client losses caused by unpredictable changes in stock prices. In fact, I never made those investments . . . .<sup>40</sup>

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<sup>35</sup> MARKOPOLOS, *supra* note 6, at 112. (“At least several of those funds had ceased operating as traditional hedge funds and had become nothing more than Madoff’s sales force. They did nothing for their clients except shovel the money directly to Madoff. They didn’t do any due diligence, they didn’t make any other investments, and they certainly did not diversify to protect their client’s money.”)

<sup>36</sup> CAMPBELL, *supra* note 11, at 92. (SPCL programs, “pulled real data off backup tapes, such as actual House 5 customer files, and then randomly generated fake variables were plugged in. A wide variety of reports emerged, including phony trade blotters, IA customer records, and stock exchange reports containing the fake trading. The files were deleted at the end of each run.”)

<sup>37</sup> *Id.* at 84. “Dan Bonventre was the operations director on the market-making and prop trading side. His problems had to do with creating false trading profits in his account.” *Id.*

<sup>38</sup> *Id.* at 92. Such programs included TRADE1701, which “did calculations that went along with trades, such as dividends. It would provide alerts if there were errors, such as the phony trade settlement dates falling on weekends when the markets were closed.” *Id.*

<sup>39</sup> *Id.* at 84.

<sup>40</sup> Transcript of Plea Proceeding at 26, United States v. Madoff, No. 09 CR 213 (S.D.N.Y. Mar. 12, 2009), available at <http://www.justice.gov/usao/nys/madoff/madoffhearing031209.pdf>.

Instead, Madoff put the money in banks and used the funds for redemptions and various personal uses such as vacations, boats, charitable contributions, and real estate.<sup>41</sup> Like other Ponzi schemes, as long as new clients could be attracted, the scheme could continue because funds from new investors were used to pay earlier ones.<sup>42</sup> Many investors had never met Madoff and were involved only through financial advisors and feeder funds.<sup>43</sup>

Madoff's fraud spread from the U.S. through Europe as word of his successes grew, and this new money breathed new support and necessary capital into the scheme.<sup>44</sup> Hearing of the impressive gains, hedge funds, and other overseas vehicles placed large sums of money with Madoff, garnered substantial commissions, and then suffered catastrophic losses.<sup>45</sup> Many investors at this time were aware that the SEC had investigated but ultimately cleared Madoff, and they viewed this clearance as the government's endorsement of Madoff's validity.<sup>46</sup>

The scheme collapsed in December 2008, following the global financial crisis, when investors sought to withdraw significant funds from their accounts in response to the economic downturn. Madoff could not find the money to fulfill the numerous requests, ultimately causing him to reveal the fraud.<sup>47</sup> The subsequent investigation eventually revealed that "Madoff had not made even one trade in many

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<sup>41</sup> CAMPBELL, *supra* note 11, at 245-47.

<sup>42</sup> MARKOPOLOS, *supra* note 6, at 104. "For a Ponzi scheme to continue to survive, you have to bring in new money faster than it is flowing out because you're robbing Peter to pay Paul. The more Pauls you have to pay, the more Peters you need to find." *Id.*

<sup>43</sup> *Id.* (explaining that many victims of Madoff's fraud were left destitute, such as Neil Friedman, who reported in 2013, "I've lived on Social Security and selling note cards since 2008. I'm trying everything, just scraping together." Friedman was not connected to Madoff directly, but through a third-party investor who promised a high return on Friedman's capital investment."). *See also Madoff Victims Recount the Long Road Back*, *infra* note 52.

<sup>44</sup> MARKOPOLOS, *supra* note 6 at 104.

<sup>45</sup> *See generally* CAMPBELL, *supra* note 11. Overall, 15,000 claims were filed, and a review of customer statements in December 2008 showed \$73.1 billion in largely fictional investments. MARKOPOLOS, *supra* note 6, at 201-02.

<sup>46</sup> *See generally* CAMPBELL, *supra* note 11.

<sup>47</sup> *Bernie Madoff's Ponzi Scheme*, *supra* note 12.

years.”<sup>48</sup> As a result of Madoff’s brazen criminal activity, he was sentenced to 150 years in federal prison.<sup>49</sup>

The revelation of Madoff’s scheme devastated his victims.<sup>50</sup> Thousands of people lost their life savings,<sup>51</sup> and the scheme’s reverberations echoed throughout the world’s financial markets.<sup>52</sup> The impact on these victims went far beyond financial loss. Victims’ impact statements revealed that they experienced “severe emotional and psychological distress” from their disastrous financial losses and from “undesired media coverage and [] public humiliation.”<sup>53</sup> One article described how victims became “faceless” despite this unwanted attention, with their pain and suffering coming second to coverage of Madoff and the financial ramifications of the scheme.<sup>54</sup> Most tragically, at least six suicides were directly attributed to the scheme.<sup>55</sup>

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<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> ALEXANDRA ROTH, *THE CLUB NO ONE WANTED TO JOIN: MADOFF VICTIMS IN THEIR OWN WORDS* 17 (Erin Arvedlund ed. 2012); *Madoff Victims Recount the Long Road Back*, WALL ST. J. (Dec. 9, 2013), <https://www.wsj.com/articles/SB10001424052702303560204579248221657387860> [<https://perma.cc/2U86-VKZ9>].

<sup>51</sup> CAMPBELL, *supra* note 11, at 166; *see also Madoff Victims Recount the Long Road Back*, *supra* note 52.

<sup>52</sup> Jason Szep, *Charities Hit Hard as Madoff Losses Mount*, REUTERS (Dec. 16, 2008), <https://www.reuters.com/article/us-madoff-charities-sb/charities-hit-hard-as-madoff-losses-mount-idUSTRE4BE6TP20081216> [<https://perma.cc/Y5Y2-KYLQ>] (explaining that Madoff’s scheme crippled many charities. Some, like the Chais Family Foundation, directly invested with Madoff and were forced to shut their doors. Others, like the Gift of Life Bone Marrow Foundation, were forced to scale back after prominent contributors lost their income.).

<sup>53</sup> David Glodstein et al., *Fraud Trauma Syndrome: The Victims of the Bernard Madoff Scandal*, 2 J. FORENSIC STUD. ACCT. & BUS., 1, 3 (2010); *see also* ROTH, *supra* note 52, at 31 (explaining that one victim wrote about finding out about the fraud from her father: “Now I understood the looks on their faces. This is far worse than anything I would have thought of in a million years . . . I couldn’t help but think about my dad and what he must be going through- not only has he just discovered that his retirement money is gone, but the money to pay off the house is gone, the car insurance, paying Grandma’s bills, everything is gone.”)

<sup>54</sup> Glodstein et al., *supra* note 55, at 2.

<sup>55</sup> CAMPBELL, *supra* note 11, at 155 (explaining that when Madoff’s scheme collapsed, Villehuchet’s was driven to suicide.); *see also* Martha Graybow & Daniel Trotta, *Bernard Madoff’s Elder Son Dead in Suicide*, REUTERS (Dec. 11, 2010), <https://www.reuters.com/article/us-madoff-son-suicide-idUSTRE6BA1GE20101212> [<https://perma.cc/2NUP-ZJFB>] (explaining that two

In response, the government established the four-billion-dollar Madoff Victim Fund in 2013.<sup>56</sup> Special Master Richard Breeden, the former U.S. SEC Chairman, charged with overseeing the fund and distributions to victims, estimated in 2020 that the fund was able to bring recoveries for more than 30,000 Madoff victims to slightly over eighty percent.<sup>57</sup>

## B. Problems with the SEC Investigation

Despite multiple regulations designed to protect the investing public, Madoff's fraud was not uncovered during its operation, even with the ample opportunity and evidence to support such a finding.<sup>58</sup> Fifteen years before the revelation of Madoff's fraud, a knowledgeable investment manager named Harry Markopolos first suggested that Madoff was running a Ponzi scheme, pointing to the virtual impossibility of the market returns outlined in Madoff's monthly statements and other indicia of fraud.<sup>59</sup> Markopolos correctly noted that

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years after Bernie Madoff confessed, his oldest son, Mark Madoff, committed suicide after facing mounting pressure from the public).

<sup>56</sup> *Madoff Victim Fund Commences its Sixth Distribution*, MADOFF VICTIM FUND (Dec. 2020), <https://madoffvictimfund.com/case-update-from-the-special-master-december-2020/> [<https://perma.cc/86AJ-4XQF>].

Of the over \$4 billion that has been made available to victims, approximately \$2.2 billion was collected as part of the historic civil forfeiture recovery from the estate of deceased Madoff investor Jeffrey Picower. An additional \$1.7 billion was collected as part of a deferred prosecution agreement with JPMorgan Chase Bank N.A. and civilly forfeited in a parallel action. The remaining funds were collected through a civil forfeiture action against investor Carl Shapiro and his family, and from civil and criminal forfeiture actions against Bernard L. Madoff, Peter B. Madoff, and their co-conspirators.

*Justice Department Announces Total Distribution of Over \$4 Billion to Victims of Madoff Ponzi Scheme*, U.S. DEP'T OF JUST. (Sept. 28, 2022), <https://www.justice.gov/opa/pr/justice-department-announces-total-distribution-over-4-billion-victims-madoff-ponzi-scheme> [<https://perma.cc/DR8K-CRWR>].

<sup>57</sup> *Madoff Victim Fund Commences its Sixth Distribution*, *supra* note 58.

<sup>58</sup> ROTH, *supra* note 52, at 17 (noting that one investor wrote, “[b]y morning, I had read everything there was to read about Madoff . . . and was relieved to hear that Madoff was a member in good standing of the Securities Investment Protection Corporation.”).

<sup>59</sup> Andrew Clark, *The Man Who Blew the Whistle on Bernard Madoff*, THE GUARDIAN (Mar. 24, 2010), <https://www.theguardian.com/business/2010/mar/24/bernard-madoff-whistleblower-harry-markopolos> [<https://perma.cc/AG6D-6JSV>].

Madoff's: impressive returns spanning a number of years despite varying market conditions, the absence of contemporaneous records of large trades, and the persistent secrecy surrounding Madoff's company all pointed to potential fraud.<sup>60</sup> Looking at Madoff's plan, Markopolos concluded that the consistently high volume of returns was impossible to replicate through legitimate means.<sup>61</sup> This indicated that Madoff was engaged in a Ponzi scheme or front-running fraud where trades were executed after the results were known.<sup>62</sup>

Markopolos took this evidence directly to the SEC and filed multiple complaints against Madoff:

In May 2000, Markopolos provided the SEC's Boston District Office (BDO) with an eight-page complaint questioning the legitimacy of Madoff's reported returns. In March 2001, Markopolos provided the BDO with a second complaint, which supplemented his previous 2000 complaint with updated information and additional analysis. Markopolos' 2001 complaint included an analysis of Madoff's returns versus the S&P 500, showing that he had only three down months versus the market's 26 down months during the same period.<sup>63</sup>

Despite this evidence, the SEC rebuffed Markopolos' complaints in 2000 and 2001.<sup>64</sup> The SEC conducted a relatively brief investigation, requested limited substantiation of requested items, and dismissed the allegations after finding the responses satisfactory.<sup>65</sup> In its perfunctory investigation,<sup>66</sup> the Agency found Markopolos' allegations speculative and unproven, while it found Madoff credible and his supporting records reliable.<sup>67</sup> The SEC failed to adequately investigate suspicious behavior and financial patterns, including erratic or inconsistent answers—particularly noted in retrospect—and hesitancy to hand over documents for SEC review.<sup>68</sup> Indeed, the complainant attempted to

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<sup>60</sup> *Id.*

<sup>61</sup> *See generally* MARKOPOLOS, *supra* note 6.

<sup>62</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 51.

<sup>63</sup> *Id.* at 47.

<sup>64</sup> *See generally Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 17.

<sup>68</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 12. (“Madoff’s responses to the examiners’ document requests should have raised suspicions because the information provided appeared incomplete and, at times, inconsistent when compared to other information provided.”); *see also* Transcript of Plea Proceedi

follow up and was firmly rebuffed.<sup>69</sup> As in many fraud cases, the complainant's proof and motives were questioned, while the schemer's explanations were readily accepted. A subsequent self-investigatory SEC Report found that inexperienced examiners were charged with investigating Madoff's finances, making it easier for fraudulent documents and fabricated figures to go unnoticed.<sup>70</sup>

On at least three occasions over the following decade, Markopolos submitted complaints to the SEC, accurately stating that the Madoff program was likely a Ponzi scheme.<sup>71</sup> Each was rejected, with only a few receiving cursory attention.<sup>72</sup> Refusing to be ignored, Markopolos submitted his third complaint in 2005 under the title, "The World's Largest Hedge Fund is a Fraud."<sup>73</sup> Although this complaint was more detailed than previous complaints and prompted a more detailed review, Madoff's word was again accepted over Markopolos' evidence.<sup>74</sup> Markopolos did not file any additional reports on Madoff's operation until Madoff revealed the scheme. Furthermore, investigators never caught Madoff; instead, facing increasing redemption requests, he revealed the scheme to his two sons, who reported the fraud to law enforcement in 2008.<sup>75</sup>

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ng at 19-24, *United States v. Madoff*, No. 09 CR 213 (S.D.N.Y. Mar. 12, 2009), available at <http://www.justice.gov/usao/nys/madoff/madoffhearing031209.pdf> [<https://perma.cc/P2SB-JDQE>]. ("In April 2004, a NERO investment management examiner had been conducting a routine examination of an unrelated registrant when it discovered internal e-mails from November and December 2003 that raised questions about whether Madoff was involved in illegal activity involving managed accounts. These internal e-mails described red flags which included: (1) incredible and highly unusual fills for equity trades; (2) misrepresentation of his options trading; (3) secrecy; (4) auditor; (5) unusually consistent and non-volatile returns over several years; and (6) fee structure.").

<sup>69</sup> Clark, *supra* note 61.

<sup>70</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 56-57.

<sup>71</sup> *Id.* at 2.

<sup>72</sup> *Madoff Whistleblower: SEC Failed to do the Math*, NAT. PUB. RADIO (Mar. 2, 2010), <https://www.npr.org/2010/03/02/124208012/madoff-whistleblower-sec-failed-to-do-the-math> [<https://perma.cc/HQC2-AJRM>].

<sup>73</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 237.

<sup>74</sup> *Id.*

<sup>75</sup> Martha Neil, *Madoff Thought Jig was up in 2006, but SEC Didn't Check Trades*, A.B.A. J. (Sept. 3, 2009), [https://www.abajournal.com/news/article/16adoff\\_thought\\_jig\\_was\\_up\\_in\\_2006\\_but\\_sec\\_didnt\\_check\\_trades](https://www.abajournal.com/news/article/16adoff_thought_jig_was_up_in_2006_but_sec_didnt_check_trades) [<https://perma.cc/XS5W-MKYN>]; see also CAMPBELL, *supra* note 11, at 106-08.



Discovery of the Madoff fraud prompted condemnation of several entities: banks that processed questionable deposits,<sup>76</sup> investment funds that forwarded monies to him,<sup>77</sup> and, most notably, the SEC. Why wasn't the case more thoroughly investigated? How could the word of a fraudster be so quickly accepted? Why weren't records subpoenaed and individuals questioned outside the Madoff organization? Critics noted that had any of the documents been independently checked, the fraud would have been uncovered, given that the stock holdings were false, records were fake, and stock transactions never occurred.<sup>78</sup> A subsequent SEC self-investigation substantiated these criticisms.<sup>79</sup>

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<sup>76</sup> *In re Bernard L. Madoff Inv. Sec. LLC*, 721 F.3d 54, 59-60 (2d Cir. 2013).

Madoff maintained a checking account at JPMorgan Chase & Co. ('JPMorgan') for more than twenty years, beginning in 1986. In the years prior to BLMIS's bankruptcy, JPMorgan collected an estimated half billion dollars in fees, interest payments, and revenue from BLMIS. The Trustee alleges that JPMorgan was 'at the very center' of Madoff's fraud and was 'thoroughly complicit' in it. Madoff's primary account with JPMorgan, the '703 Account,' was where hundreds of billions of dollars of customer money were 'commingled and ultimately washed.' The customer funds deposited into the 703 Account for 'split-strike' securities transactions were instead funneled to other customers to sustain the illusion of large and reliable returns on investment. The 703 Account was a retail checking account, not a commercial account. Billions of dollars from thousands of investors were deposited without being segregated or transferred to separate sub-accounts. These accounts exhibited, on their face, a 'glaring absence of securities activity.

*Id.*; see also *Sec. Inv'r. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 608 B.R. 165, 170 (2019) ("the IA business did not purchase or sell securities for its consumers, and used historical stock prices to show backdated, profitable trades in customer accounts.").

<sup>77</sup> See *SSR II LLC v. John Hancock Life Ins. Co. (USA)*, 37 Misc. 3d 1204, 1204(A) (2012).

<sup>78</sup> *SEC Charges Madoff's Director of Operations with Falsifying Accounting Records and Siphoning Investor Funds*, SEC. EXCH. COMM'N (Feb. 25, 2010), <https://www.sec.gov/news/press/2010/2010-28.htm> [<https://perma.cc/5649-MTE6>] (Frank DiPascali, Daniel Bonventre, and others ran a separate unit of Madoff's company to produce fraudulent documents and handle the various fake investments. Bonventre himself said that "the firm used more than \$750 million in investor funds to artificially improve reported revenue and income.").

<sup>79</sup> SEC REPORT NO. OIG-509, *supra* note 7, at 30 ("Responses by Madoff to the document requests contradicted the Hedge Fund Manager's complaint and the 2001 articles. For example, Madoff's claim that his firm did not manage or advise hedge funds was contradicted by the articles that reported Madoff was managing billions of dollars in assets.").

In the aftermath, many called the fraud a failure of the financial regulatory system, prompting calls for reform.<sup>80</sup> Instead of thoroughly investigating the company to address the complaints it received, the SEC essentially took Madoff at his word.<sup>81</sup> For many, including financial experts at the SEC, the thought of a Wall Street titan like Madoff operating a Ponzi scheme of such a scale seemed implausible. Nevertheless, the systemic problems that allowed Madoff to escape scrutiny now carry over to adjudicating other fraud claims in court.

## II. *IQBAL* AND THE PLAUSIBILITY STANDARD

Two Supreme Court cases, *Bell Atlantic v. Twombly* and *Ashcroft v. Iqbal* (collectively, *Iqbal*),<sup>82</sup> compel the same type of truncated evaluation that was insufficient to reveal the fraud in Madoff. Far from learning the lessons of Madoff, our civil court system created a framework for adjudication of fraud cases that produces the same: risk for miscalculation, reward for falsification of records, misplaced assessment of credibility, and hasty determinations based on limited records. Accepting the words of those accused of fraud and intensely scrutinizing the sufficiency of documentation from victims should not be the standard.<sup>83</sup>

### A. The Development of the *Iqbal* Pleading Standard

Historically, a civil complaint only needed to lay out the elements of a claim. The Federal Rules of Civil Procedure simply required a plain statement of the claim: “A pleading that sets forth a claim for relief shall contain (1) a short and plain statement of the claim showing that the

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<sup>80</sup> *Id.* at 22. The SEC admitted, “the complaints all contained specific information and could not have been fully and adequately resolved without thoroughly examining and investigating Madoff for operating a Ponzi scheme.” *Id.*

<sup>81</sup> *Id.* at 23. “[T]he SEC did seek records from the Depository Trust Company (DTC) (an independent third party) but sought copies of records of such records from Madoff himself. Had they sought records from DTC, there is an excellent chance that they would have uncovered Madoff’s Ponzi Scheme in 1992.” *Id.*

<sup>82</sup> See *Ashcroft v. Iqbal*, 556 U.S. 662, 680 (2009); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007). Both cases have created the *Iqbal* standard of pleading, which requires a plaintiff to state a plausible cause of action to have their case move forward.

<sup>83</sup> Roger Michalski, *Assessing Iqbal after One Year: Effects and Proposals*, HARV. L. & POL’Y REV. ONLINE (2010) (“Given the inherent secrecy of such conspiracies, potential plaintiffs typically lack access to internal corporate communication that could substantiate,” a plaintiff’s fraud claims.).

pleader is entitled to relief, and (2) a demand for judgment for the relief which the pleader seeks.”<sup>84</sup> Under this “notice pleading” standard, the court took factual allegations as true and only examined the assertions after both parties had the opportunity to take discovery.<sup>85</sup>

Under this standard, a motion to dismiss simply challenged the form and sufficiency of the complaint.<sup>86</sup> The Supreme Court stated that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.”<sup>87</sup> Thus, a statement that a defendant was negligent or breached a contract would not be sufficient because the court would not question or attempt to assess factual statements driving those legal conclusions at the pleading stage. Therefore, a motion to dismiss would generally be denied if the complaint set forth a claim, and the sufficiency of proof would be evaluated after discovery through a motion for summary judgment or a trial.<sup>88</sup>

The notice pleading system was challenged in *Twombly*, where the Supreme Court held that plaintiffs must plead plausible facts in antitrust matters.<sup>89</sup> The Court clarified that pleading plausible facts “does not impose a probability requirement at the pleading stage; it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence” to support the complaint.<sup>90</sup> The complaint must plead facts that are more than “merely consistent with” the alleged conduct.<sup>91</sup> Instead, the Court stated that the alleged facts must “possess enough heft” to show a judge that the claim is plausible.<sup>92</sup>

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<sup>84</sup> FED. R. CIV. P. 8(a).

<sup>85</sup> *Papasan v. Allain*, 478 U.S. 265, 286 (1986) *citing* *Briscoe v. LaHue*, 663 F.2d 713, 723 (7th Cir. 1981); *see also* 2A J. Moore & J. Lucas, *Moore’s Federal Practice* 12.07, p. 12-64, and n. 6 (1985).

<sup>86</sup> *See generally* Benjamin Spencer, *Understanding Pleading Doctrine*, 108 MICH. L. REV. 1, 4 (2009).

<sup>87</sup> *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

<sup>88</sup> *How Courts Work: Motion for Directed Verdict/Dismissal*, A.B.A. (Sept. 09, 2019), [https://www.americanbar.org/groups/public\\_education/resources/law\\_related\\_education\\_network/how\\_courts\\_work/motiondismiss/#](https://www.americanbar.org/groups/public_education/resources/law_related_education_network/how_courts_work/motiondismiss/#) [<https://perma.cc/AUK2-Y9CY>].

<sup>89</sup> *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

<sup>90</sup> *Id.* at 556.

<sup>91</sup> *Id.* at 557.

<sup>92</sup> *Id.*

*Iqbal* extended the holding in *Twombly* to all civil actions filed in federal courts.<sup>93</sup> Under *Iqbal*, the plaintiff must provide “factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged” to have his or her claim survive a motion to dismiss.<sup>94</sup> To avoid dismissal, the complaint must be supported by competent documentation referred to or included in the pleading.<sup>95</sup> If the plaintiff fails to provide adequate evidence to establish a prima facie case on the elements of his or her claim, it is deemed not plausible and dismissed.<sup>96</sup> A court may dismiss the claim with or without prejudice, and it becomes the plaintiff’s burden if given the opportunity, to amend his or her complaint to lay out the claim in sufficient detail to avoid dismissal.<sup>97</sup>

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<sup>93</sup> See *Ashcroft v. Iqbal*, 556 U.S. 662, 687 (2009) (holding that a claim must plead sufficient facts for it to be considered plausible).

<sup>94</sup> Ray Brescia, *Legal scholarship highlight: The impact of Ashcroft v. Iqbal on civil rights cases*, SCOTUS BLOG (Nov. 14, 2012), <https://www.scotusblog.com/2012/11/legal-scholarship-highlight-the-impact-of-ashcroft-v-iqbal-on-civil-rights-cases/> [<https://perma.cc/APG4-JLR3>].

<sup>95</sup> See Kenneth S. Klein, *Ashcroft v. Iqbal Crasher Rule 8 Pleading Standards on the Unconstitutional Shores*, 88 NEB. L. REV. 261, 264 (2009) (“The opinion in *Twombly* suggested the Court was amenable to using the Rule 12(b)(6) motion to dismiss as a screening device to identify and quickly dispose of perceived frivolous litigation, and so triggered a vigorous, and important, debate about the desirability of imposing a system-wide, heightened Rule 8 fact pleading requirement for civil cases in federal court.”).

<sup>96</sup> *Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 510 (2002). The Third Circuit explained that a prima facie case is “an evidentiary standard, not a pleading requirement,” and hence is “not a proper measure of whether a complaint fails to state a claim.” *Fowler v. UPMC Shadyside*, 578 F.3d 203, 213 (3d Cir. 2009). The Fourth Circuit cited a seemingly more demanding standard:

In *Iqbal*, the Court stated that [t]o survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is *plausible on its face*. The plausibility standard requires a plaintiff to demonstrate more than a sheer possibility that a defendant has acted unlawfully. It requires the plaintiff to articulate facts, when accepted as true, that ‘show’ that the plaintiff has stated a claim entitling him to relief, i.e., the ‘plausibility’ of entitlement to relief.

*Francis v. Giacomelli*, 588 F.3d 186, 193 (4th Cir. 2009) (internal citations and quotations omitted).

<sup>97</sup> *Ashcroft v. Iqbal*, 556 U.S. 662, 685-86 (2009).

## B. The Plausibility Standard Is Unclear

*Iqbal* requires that a complaint allege “enough facts to state a claim to relief that is plausible on its face.”<sup>98</sup> Plausibility, a central element in the *Iqbal* standard, has had varying meanings when used in judicial opinions and common parlance. Plausibility exists between possibility and probability,<sup>99</sup> and courts differ over what is required to meet this standard.<sup>100</sup> The Third Circuit held that the pleading standard “is not akin to a ‘probability requirement.’”<sup>101</sup> However, the Tenth Circuit seems to utilize a probability standard, stating that:

The mere metaphysical possibility that some plaintiff could prove some set of facts in support of the pleaded claims is insufficient; the complainant must give the court reason to believe that this plaintiff has a reasonable likelihood of mustering factual support for these claims.<sup>102</sup>

In essence, the question is whether a court finds sufficient evidence to support each element of a legal claim. A court evaluates that material on this somewhat subjective plausibility standard,<sup>103</sup> which can lead to

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<sup>98</sup> *Francis*, 588 F.3d at 697, citing *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

<sup>99</sup> To understand the impact caused by this difference between possible and probable interpretations consider the game of craps. In a game of craps, an individual has a one-sixth chance of rolling a seven on his or her first roll, which is called a pass (thirty-six dice combinations, six possibilities to roll seven). If plausible is synonymous with conceivable, an initial pass is plausible. If plausible is synonymous with probable, or likely, the analysis changes. With only a one-sixth chance of occurrence, a pass is unlikely, so it would not be considered plausible. The interpretation of plausible as possible or probable creates a meaningful difference in the outcome.

<sup>100</sup> *Implausible*, CAMBRIDGE ENG. DICTIONARY, 10<sup>th</sup> Ed. 2007, <https://dictionary.cambridge.org/us/dictionary/english/implausible> [<https://perma.cc/9TBP-Q26U>] (last visited Oct. 20, 2023).

<sup>101</sup> *Covington v. Intern Ass’n of Approved Bask.*, 710 F.3d 114, 118 (3d Cir. 2013).

<sup>102</sup> *Ridge at Red Hawk LLC v. Schneider*, 493 F.3d 1174, 1177 (10th Cir. 2007).

<sup>103</sup> Henry S. Noyes, *The Rise of the Common Law of Federal Pleading: Iqbal, Twombly, and the Application of Judicial Experience*, 56 VILL. L. REV. 857, 858-59 (2012) (noting that there is a difference of opinion between early commentators and current legal scholars as to whether the application of ‘judicial experience’ requires the court to make a subjective determination).

different outcomes depending on the court, district, or judge evaluating the complaint.<sup>104</sup>

The *Iqbal* pleading standard rests on the principle that parties will provide reasonably accurate information at the motion stage, where the court can decide the case's "plausibility."<sup>105</sup> This plausibility determination is a "context-specific task that requires the reviewing court to draw on its judicial experience and common sense."<sup>106</sup> The ultimate premise behind *Iqbal* is that discovery will not significantly aid this decision-making process, and early determination will save time and money.<sup>107</sup> However, plausibility changes as information is added. As in *Madoff*, claims can be well-founded, but the claimant may lack complete information about a critical element, limiting the claim's recognition. History is replete with instances where events were misinterpreted based on incorrect initial impressions,<sup>108</sup> particularly when one party actively seeks to deceive the public.<sup>109</sup>

*Iqbal*'s plausibility standard answers some complex issues, including what claims have social utility and how we curtail baseless claims.<sup>110</sup> However, since *Iqbal*, dismissals have risen significantly as it

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<sup>104</sup> Brandon L. Garrett, *Applause for the Plausible*, 162 U. PA. L. REV. ONLINE 221, 224 (2014), [https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1126&context=penn\\_law\\_review\\_online](https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1126&context=penn_law_review_online) [<https://perma.cc/Z8KV-LZGW>].

<sup>105</sup> See *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009).

<sup>106</sup> *Id.* at 679.

<sup>107</sup> See *id.* at 685.

<sup>108</sup> Illustrative examples include the U.S.S.R.'s inaccurate reports of the Chernobyl incident and the initial reaction and subsequent spread of misinformation during the COVID-19 pandemic. See Alla Yaroshinskai, *Chernobyl: The Big Lie*, 35 INDEX ON CENSORSHIP 2, 20 (2006); Daniel Funke & Katie Sanders, *Lie of the Year: The Downplay and Denial of the Coronavirus*, POLITIFACT (Dec. 16, 2020), <https://www.politifact.com/article/2020/dec/16/lie-year-coronavirus-downplay-and-denial/> [<https://perma.cc/M9M5-6582>].

<sup>109</sup> Take the Watergate scandal as an example. A break-in at the Watergate Hotel was, at first glance, just a break-in. Later information indicated the scandal's larger depth. While the scandal was uncovered and President Nixon ultimately resigned, the example shows how new information can drastically change the plausibility of an allegation. See RICK PERLSTEIN, *THE INVISIBLE BRIDGE: THE FALL OF NIXON AND THE RISE OF REAGAN* 75-250 (2013).

<sup>110</sup> In *McCauley v. City of Chicago*, a federal judge stated the *Iqbal* standard, as overbroad as it is, likely would have seen the removal of landmark civil rights cases based upon the insufficiency of proofs there. "The Court's shift to 'plausibility' pleading, and the assignment of interpretation of that standard to the subjective common sense of individual judges, has markedly increased the danger

provides defendants the ability to strike claims at the pleading stage.<sup>111</sup> While it has lightened the court's burden, many legal scholars suggest the *Iqbal* standard has left injustice in its wake.<sup>112</sup> A study published by the Virginia Law Review found that civil rights and employment discrimination claims were more likely to be dismissed under *Iqbal*.<sup>113</sup> Another study conducted by the Federal Judicial Center (FJC) concluded that dismissals were more common in civil cases dealing with finance.<sup>114</sup> Other articles have confirmed the FJC's study while arguing that *Iqbal's* overall impact is more extensive than reported.<sup>115</sup> Moreover, defendants were emboldened by the *Iqbal* standard, with motions to dismiss based on *Iqbal* routinely filed and granted, preventing scrutiny of defendants' activities.<sup>116</sup>

### C. The Plausibility Standard Shifts the Defendant's Summary Judgment Burden

The summary judgment standard tests the sufficiency of the plaintiff's claim, and it does so by requiring the fraud defendant, who professes an innocent explanation, to document his position and support

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of throwing out the proverbial baby with the bathwater." *McCauley v. City of Chicago*, 671 F.3d, 611, 627 (7th Cir. 2011).

<sup>111</sup> Adam Liptak, *Supreme Court Ruling Altered Civil Suits, to Detriment of Individuals*, N.Y. TIMES (May 18, 2015), <https://www.nytimes.com/2015/05/19/us/9-11-ruling-by-supreme-court-has-transformed-civil-lawsuits.html/> [https://perma.cc/N6FP-CNY8]. After the *Iqbal* decision, the motion to dismiss became a powerful tool in a civil defendant's toolbox, with statistics indicating a stark rise in dismissals filed since 2009. "Before *Iqbal*, cases brought by individuals represented by lawyers were dismissed 42 percent of the time. After *Iqbal*, the rate was 59 percent." *Id.*

<sup>112</sup> Alexander A. Reinert, *Measuring the Impact of Plausibility Pleading*, 101 VA. L. REV. 2117, 2146 (2015).

<sup>113</sup> The Virginia Law Review analysis indicates a significant increase in dismissals after *Iqbal*. *Id.* Tort cases pre-*Iqbal* were dismissed at 37%; post-*Iqbal* that number increased to 47%. *Id.* Civil rights cases pre-*Iqbal* were dismissed at 47%, only for that number to rise to 66% after the *Iqbal* decision. Finally, cases dealing with financial instruments, such as those similar to Madoff, saw a substantial increase. *Id.* Before the *Iqbal* decision, finance cases were dismissed due to a plaintiff's failure to state a claim at 48%; only for that number to increase to 70% post-*Iqbal*. *Id.*

<sup>114</sup> See generally JOE S. CECIL ET AL., MOTIONS TO DISMISS FOR FAILURE TO STATE A CLAIM AFTER *IQBAL* (Fed. Jud. Ctr. 2021).

<sup>115</sup> Lonny Hoffman, *Twombly and Iqbal's Measure: An Assessment of the Federal Judicial Center's Study of Motions to Dismiss*, 6 FED. CT. L. REV. 1, 36 (2012).

<sup>116</sup> See *id.*

it with an affidavit or other relevant materials while being subject to potential punishments for misinformation.<sup>117</sup> Federal Rule of Civil Procedure 56 (c)(1)(A) provides in part:

A party asserting that a fact cannot be or is genuinely disputed must support the assertion by citing particular parts of materials in the record, including depositions, documents, electronically stored information, affidavits or declarations, stipulations (including those made for purposes of the motion only), admissions, interrogatory answers, or other materials.<sup>118</sup>

A party's assertion that a fact is legitimately disputed must be supported by the materials in the record or his affidavit.<sup>119</sup> In contrast, under *Iqbal*, the sufficiency of the plaintiff's claim is tested at the pleading stage, where the defendant's counsel simply can question the adequacy of the pleading and present alternate unsworn explanations of the conduct, which the court may accept.<sup>120</sup> While an affidavit carries penalties of perjury, the attorney's brief has a lenient standard of good faith.<sup>121</sup>

*Iqbal* shifts the burden from providing documentary evidence or sworn statements to a much easier one of having the defendant's skilled counsel question or scrutinize the claim.<sup>122</sup> The defendant's counsel may ask why the alleged dates of supposed fraudulent transfers aren't set forth and which transactions are suspected to be false, ultimately submitting that the complaint is conclusory under *Iqbal* while sidestepping the question of whether the allegations were true.

#### **D. The Plausibility Standard Harms Victims of Fraud**

The argument that courts can quickly and accurately evaluate fraud cases based on the evidence at the pleading stage is misplaced. In a typical fraud, the victim generally does not have access to relevant, truthful documents about the scheme.<sup>123</sup> Consider two claims:

- Case One involves a sophisticated fraud where the value of leases in housing developments has been overstated, and individual investors will suffer five and six-figure losses,

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<sup>117</sup> See FED. R. CIV. P. 56.

<sup>118</sup> FED. R. CIV. P. 56 (c)(1)(A).

<sup>119</sup> FED. R. CIV. P. 56 (c)(1)(A).

<sup>120</sup> See generally *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>121</sup> FED. R. CIV. P. 11(b).

<sup>122</sup> See generally *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>123</sup> Michalski, *supra* note 85.



devastating to some victims. However, most of the details of the scheme are hidden and can only be uncovered through a reasonably thorough audit, and a court filing would only present a victim's belief that she was deceived. The defendant will hire skilled counsel, have letters threatening frivolous claims sanctions, and move for dismissal based upon *Iqbal*.

- Case Two involves a bag of peanuts, where 50 peanuts were promised, but only 47 or 48 were provided, with the package costing about \$1.50. An independent expert has reviewed the bags of peanuts and, based upon available information, can show the average consumer is shortchanged 2 or 3 peanuts, or 4 cents if one peanut is missing. The damage to each consumer is mere pennies, but the deception can be shown and documented. Therefore, the pleading setting forth the claim would satisfy *Iqbal* since the complaint can detail the claim. Thus, counsel would have no difficulty documenting and supporting the claim of the missing peanut.

The peanut claim is easily shown, and the harm to the average consumer is minimal. In contrast, the housing fraud can cause devastating losses, notwithstanding its proof challenges at the pleading stage. Claims involving minimal but discernible losses with easily found supporting material meet the legal standard, but more significant claims involving substantial injury and ongoing schemes are inequitable and a misuse of court resources.

Neither *Twombly*<sup>124</sup> nor *Iqbal*<sup>125</sup> involved fraud claims; *Twombly* was an antitrust case, and *Iqbal* was a constitutional targeting claim. Nonetheless, the courts have quickly applied the rulings to a wide variety of issues—including fraud—and these holdings now represent the standard for the adjudication of fraud claims.<sup>126</sup> *Iqbal* is particularly misplaced in fraud, where early information is the key to accurate decisions. Requiring plaintiffs in fraud actions to present direct evidence of culpability, where a fraudster can cover his or her misrepresentations, is misplaced.<sup>127</sup> The *Iqbal* standard places the victim on trial. Since the

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<sup>124</sup> See generally *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007).

<sup>125</sup> See generally *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>126</sup> FED. R. CIV. P. 9(b).

<sup>127</sup> This article does not address the overall wisdom of *Iqbal*, just its imprudence in fraud cases where information is hidden from or misrepresented to the victim, as in Madoff. The *Iqbal* standard has been a topic of contention in the legal community since it was rendered. One commentator states:

defendant does not need to proffer any evidence, hearings are usually easy for the defendant. At the same time, the plaintiff and counsel face detailed questioning about the adequacy of their proofs.<sup>128</sup>

At the very least, denying plaintiffs the ability to access necessary information to improve the plausibility of their allegations delays justice – and justice delayed is justice denied.<sup>129</sup> This maxim particularly applies to fraud claims, where each claim is distinct, expensive to prepare, and fact-sensitive.<sup>130</sup> Moreover, once a fraud is identified and publicized, and arrests are made (whether Madoff or FTX), assets are quickly depleted, and a receiver or bankruptcy court frequently carries out division.<sup>131</sup> Delayed civil remedies could result in no restitution being available for fraud victims.

### III. PROBLEMS WITH APPLYING *IQBAL* TO FINANCIAL FRAUDS AND PONZI SCHEMES

#### A. The Tools to Uncover Deception Are Not Available Before a Motion to Dismiss

The law provides a range of discovery tools that give plaintiffs the ability to uncover evidence of fraud. However, these tools typically are not available to plaintiffs until after the *Iqbal* motion assesses the claim.

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Beyond reflecting an errant interpretation of Rule 9 (B), the *Iqbal* understanding has resulted in tremendous harm to litigants seeking to prosecute their claims. Lower courts have embraced the *Iqbal* revision of Rule 9(b) with zeal, dismissing claims for failure to articulate facts underlying condition-of-mind left, right, and center. This is undesirable not only because it turns on its head a rule that was designed to facilitate rather than frustrate these claims, but also because it contributes to the overall degradation of the rules as functional partners in the larger civil justice enterprise of faithfully enforcing the law and vindicating wrongs.

Spencer, *supra* note 26, at 1017.

<sup>128</sup> *Id.* at 1042.

<sup>129</sup> Allesandro Melcarne et al., *Is Justice Delayed Justice Denied? An Empirical Approach*, 65 Int'l Rev. of Law and Econ. 1, 8 (2021) (finding through empirical evidence that there is a strong positive relationship between judicial performance and quality and estimating a significant negative relationship between judicial delay and the quality of justice).

<sup>130</sup> Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STAN. J. L. BUS. & FIN., 183, 242 (2009).

<sup>131</sup> *See e.g., id.* at 215.

For example, cross-examination subjects each statement to scrutiny by the opponent.<sup>132</sup> A proponent must carefully craft an affidavit during trial or deposition, and he or she must answer questions reasonably quickly, making deception more difficult.<sup>133</sup> Additionally, third-party subpoenas allow a party's materials to be compared with what an uninterested third party produces to verify its credibility.<sup>134</sup>

Without the opportunity for discovery, a plaintiff is generally required to substantiate his or her claim through competent evidence at the pleading stage.<sup>135</sup> The complaint is dismissed if the material is insufficient, generally with no opportunity for discovery or investigation.<sup>136</sup> The defendant will not be questioned, and no third-party material will be obtained. In short, *Iqbal* prevents the plaintiff from being able to uncover a carefully conceived fraud against a party willing to provide false material to hide it.<sup>137</sup>

Even though the defendant is accused of deception in a fraud claim, *Iqbal* assumes the defendant's credibility and shifts the burden to the plaintiffs to articulate support for their claim at the outset. At trial, courts allow jurors to apply the doctrine *falsus in unum, falsus in omnibus* (false in one, false in all).<sup>138</sup> Under this doctrine, the jury may reject the entirety of testimony if it finds the witness provided false testimony in one area.<sup>139</sup> *Iqbal* effectively eliminates this important doctrine, requiring the plaintiff to substantiate alleged facts in order to proceed.<sup>140</sup>

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<sup>132</sup> FED. R. EVID. 611(b).

<sup>133</sup> FED. R. CIV. P. 12(b)(6).

<sup>134</sup> See FED. R. CIV. P. 45.

<sup>135</sup> Caroline N. Mitchell et al., *Ashcroft v. Iqbal: The New Federal Pleading Standard*, JONES DAY (June 2009), <https://www.jonesday.com/en/insights/2009/06/iashcroft-v-iqbali-the-new-federal-pleading-standard> [<https://perma.cc/BS73-R6JG>].

<sup>136</sup> Richard Martin, *Federal Court Motions to Dismiss and the Standard for Overcoming Them*, LAMOTHE L. FIRM (May 25, 2017), <https://lamothefirm.com/2017/05/25/federal-court-motions-to-dismiss-and-the-standard-for-overcoming-them/> [<https://perma.cc/868J-5BPU>].

<sup>137</sup> See generally SEC REPORT NO OIG-509, *supra* note 7.

<sup>138</sup> *State v. Fleckenstein*, 60 N.J. Super. 399, 408 (App. Div. 1960). (“The maxim ‘falsus in uno falsus in omnibus,’ is not a mandatory rule of evidence, but rather a presumable inference that a jury [or judge sitting without a jury] may or may not draw when convinced that an attempt has been made to mislead them by a witness in some material respect”).

<sup>139</sup> See *State v. Guida*, 118 N.J.L. 289, 297 (1937).

<sup>140</sup> See *Bausch v. Stryker Corp.*, 630 F.3d 546, 559 (7th Cir. 2010) (noting plaintiffs' pleading burden); *Robertson v. Sea Pines Real Estate Cos., Inc.*, 679 F.3d 278,

Under *Iqbal*, lower courts are encouraged to rely upon the papers submitted by a person accused of fraud when considering a motion to dismiss, essentially asking judges to rely on evidence that may ultimately be found misleading or distorted. Truthful allegations inadequately supported are rejected and deemed conclusory. At the same time, the schemer's false statements or deceptive explanation may be quickly accepted and only years later—and after many more victims have been impacted—be found to be false. A deceitful company intent on avoiding liability will likely follow Madoff's example by providing false statements during both the scheme and the investigations.

Deficiencies in the Madoff investigations show the problem of securing reliable information from those engaged in deception. When asked to verify banking information and funds, Madoff or his staff fabricated records and even provided documents that were roughed up to show wear consistent with age.<sup>141</sup> Indeed, Madoff walked into the SEC interview without counsel (to show he had nothing to hide) and chastised the staff for interfering with the conduct of his business.<sup>142</sup> Madoff seemed to have an instinctive ability to pass off fabricated information as credible. The SEC Report following the fraud detailed the hazards of accepting the accused's statements at face value; it referenced multiple points in the investigation where even a limited inspection or verification would have uncovered the fraud:

As with the examinations, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations but failed to follow up on inconsistencies. They rebuffed offers of additional evidence from the complainant and were confused about certain critical and fundamental aspects of Madoff's operations. When Madoff provided evasive or contradictory answers to important questions in testimony, they simply accepted as plausible his explanations.<sup>143</sup>

The SEC consistently resolved factual disputes and credibility issues in favor of the defendant who committed the fraud and against the

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291 (4th Cir. 2012) (discussing *Twombly* and *Iqbal*'s "requirement of nonconclusory factual detail at the pleading stage"); *see also* *ABB Turbo Systems AG v. TurboUSA, Inc.*, 774 F.3d 979, 988 (Fed. Cir. 2014) (There is a periodic language that the burden may be tempered "by the recognition that a plaintiff may only have so much information at his disposal at the outset").

<sup>141</sup> SEC REPORT NO. OIG-509 *supra* note 7, at 18.

<sup>142</sup> *Id.* at 12.

<sup>143</sup> *Id.* at 24.

complainant and the public.<sup>144</sup> The SEC's failed investigation begs the question: if a trained body whose job is to detect fraud could not detect fraud in a sixty-billion-dollar scheme in which virtually every transaction was concocted, why do we assume a judge with fewer tools on a motion to dismiss can reach the correct result?

### **B. A Defendants' Attorneys Cannot Be Relied Upon to Reveal the Fraud**

The crime-fraud exception to the attorney-client privilege rule allows attorneys to reveal confidential client information if the client uses the attorney's services as part of a crime or fraud.<sup>145</sup> Attorneys do not want to enable criminals and fraudsters to utilize their services to avoid detection; however, this exception is narrow in its application.<sup>146</sup> Attorneys owe their clients a fiduciary duty and a duty of confidentiality and loyalty;<sup>147</sup> in order to reveal information showing his or her client's potential guilt, the attorney must *know* that the client will use his or her services to advance a crime or fraud.<sup>148</sup>

During its review of the failures of the Madoff investigation, the SEC identified instances in which Madoff's counsel appeared to mislead or misdirect investigatory staff.<sup>149</sup> However, an attorney is ethically obligated to disclose only statements he or she knows to be

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<sup>144</sup> *Id.*

<sup>145</sup> MODEL RULES OF PRO. CONDUCT r. 1.6(b)(2) (AM. BAR ASS'N 2003) (stating "A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services").

<sup>146</sup> David Schultz, *The Crime Fraud Exception in a Self-Regulating Tool for Attorneys*, BLOOMBERG LAW (Mar. 21, 2023, 4:00 AM), <https://news.bloomberglaw.com/us-law-week/the-crime-fraud-exception-is-a-self-regulating-tool-for-attorneys> [<https://perma.cc/4L6K-DEGU>] (noting "Attorney-client confidentiality is a central concept of American law. Yet this privilege can hide, not enable, illegal behavior.").

<sup>147</sup> Adam Barone, *What is a Fiduciary Duty? Examples and Types Explained*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/042915/what-are-some-examples-fiduciary-duty.asp> [<https://perma.cc/X9GW-YK5A>] (last updated May 24, 2023).

<sup>148</sup> *The Crime-Fraud Exception to the Attorney-Client Privilege*, NOLO, <https://www.nolo.com/legal-encyclopedia/the-crime-fraud-exception-the-attorney-client-privilege.html> [<https://perma.cc/2W7S-WN3Q>] (last visited Nov. 10, 2023).

<sup>149</sup> *See generally* SEC REPORT NO OIG-509, *supra* note 7.

false,<sup>150</sup> and failure to uncover or reveal the deception, in the absence of proof of knowledge, is generally not actionable.<sup>151</sup> Therefore, if the client does not say the magic words (a statement is false or a document is fraudulent), most defense lawyers will assume they can present it as part of their advocacy role. Furthermore, there is generally no obligation of a reasonable inquiry to uncover facts favorable to the other side or to provide a complete and accurate picture.<sup>152</sup>

Courts should recognize this narrow scope of an attorney's duties when considering the application of *Iqbal* to fraud cases. A defendant's lawyers are unlikely to reveal fraud, and reliance upon them to do so is misplaced. After surviving a motion to dismiss, discovery allows an attorney to gather considerable information from their client, investigate this information more thoroughly, and analyze the plaintiff's claim. At each of these stages, an attorney becomes more likely to gain actual knowledge that their services are being used to advance fraud. Therefore, courts should recognize not only the plaintiff's ability to better uncover the fraud post-*Iqbal* but also the fraudster's attorneys.

### **C. Fraud Defendants Are Protected by F.R.C.P. 9's Requirement to Plead with Particularity**

One concern of the *Iqbal* Court was protecting a defendant called to proceed with the expensive discovery of an ultimately meritless claim.<sup>153</sup> However, fraud cases already provide significant protection to a defendant. A fraud claim must be pled with particularity under Rule 9(b),<sup>154</sup> and even a truthful claim may be dismissed if not pled correctly.<sup>155</sup> Courts typically require a plaintiff to specify who, what, when, where, and how a fraud is perpetrated and explain why it is false

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<sup>150</sup> Laura Harshbarger, *Emergency Ethics: To Disclose or Not to Disclose, That is the Question*, BOND, SHOENECK, & KING LLC (2012), <https://nysba.org/app/uploads/2020/02/EmergencyEthics.pdf> [<https://perma.cc/ZP37-NGB6>].

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> Robert G. Bone, *Twombly, Pleading Rules, and the Regulation of Court Access*, 94 IOWA L. REV. 873, 884 (2009).

<sup>154</sup> FED. R. CIV. P. 9(b).

<sup>155</sup> FED. R. CIV. P. 9(b). Rule 9(b) requires "a complaint alleging fraud (1) specify the statements that a plaintiff contends were fraudulent; (2) identify the speaker; (3) state where and when the statements were made; and (4) explain why the statements were fraudulent." *United States ex rel. Chorches v. Am. Med. Response, Inc.*, 865 F.3d 71, 81 (2nd Cir. 2017).

or deceptive.<sup>156</sup> Thus, even without *Iqbal*, there is still a risk of a meritorious claim failing to satisfy the demanding pleading standards applicable to fraud cases under F.R.C.P. Rule 9.

*Iqbal* provides another unnecessary layer of protection for the culpable defendant, making an already difficult claim even harder. The burgeoning number of frauds, ranging from phishing to identity theft to sophisticated telemarketing schemes,<sup>157</sup> attests to the need for better civil enforcement, not more barriers for victims. The fact-sensitive and hidden nature of many claims is a barrier to criminal or regulatory enforcement, as well as civil claims due to *Iqbal*. These barriers, combined with the particularity standard under F.R.C.P. Rule 9, make fraud claims a complicated and almost untenable case to pursue.

Additionally, while some areas of law may be over-litigated, this is not the case with individual fraud claims. For example, a plaintiff's lawyer may file several claims involving the same product in mass tort litigation.<sup>158</sup> Once substantial research is completed, complainants can easily file similar claims. The fraud claim, however, is unlikely to have those economies of scale because each fraud is usually case-specific, involving different persons, claims, and facts.<sup>159</sup> Furthermore, culprits rarely acknowledge wrongdoing, and lengthy litigation is frequent, which allows fraudsters to conceal their scheme or their money further.<sup>160</sup> Thus, once a fraudster is caught and his or her scheme uncovered, there are frequently insufficient funds to cover a claim.<sup>161</sup>

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<sup>156</sup> FED. R. CIV. P. 9.

<sup>157</sup> Aaron Holmes, *Hackers Are Getting Better At Tricking People Into Handing Over Passwords*, BUS. INSIDER, [www.businessinsider.com/phishing-scams-getting-more-sophisticated-what-to-look-out-for-2020-2](https://www.businessinsider.com/phishing-scams-getting-more-sophisticated-what-to-look-out-for-2020-2) [https://perma.cc/E3CL-LVQM] (last updated July 18, 2020).

<sup>158</sup> See Christy Bieber, *What is a Mass Tort? Legal Definition & Examples*, FORBES ADVISOR, <https://www.forbes.com/advisor/legal/personal-injury/mass-tort#> [https://perma.cc/MB7N-A2K8] (last updated May 19, 2023).

<sup>159</sup> See generally Jim Donelon, *Fraud: A Crime that Affects Everyone*, LA. DEP'T OF INS., [https://www.lidi.la.gov/docs/default-source/documents/publicaffairs/consumerpublications/insurance-fraud-a-crime-that-affects-everyone.pdf?sfvrsn=fe8f7c52\\_33](https://www.lidi.la.gov/docs/default-source/documents/publicaffairs/consumerpublications/insurance-fraud-a-crime-that-affects-everyone.pdf?sfvrsn=fe8f7c52_33) [https://perma.cc/HD52-K5VS] (last visited Oct. 21, 2023).

<sup>160</sup> Hannah Miller, *Understanding the Police Response to Fraud*, PERPETUITY RSCH. (Dec. 3, 2018), <https://perpetuityresearch.com/3131/understanding-the-police-response-to-fraud/> [https://perma.cc/ZSQ3-KV55].

<sup>161</sup> James Chen, *Ponzi Schemes: Definition, Examples, and Origins*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/ponziscHEME.asp> [https://perma.cc/WQQ5-7GY7] (last updated May 27, 2023).

Therefore, given their cost, complexity,<sup>162</sup> and inability to duplicate in further proceedings, fraud claims are not overrepresented in the courts.<sup>163</sup>

#### **D. *Iqbal's* Pleading Standard Exacerbates Inequities in the Justice System for Fraud Victims**

The rise in a wide variety of fraudulent schemes testifies to inequities in both criminal and civil enforcement. While many have spoken of the harshness of the legal system, Madoff's punishment for the largest fraud in history was overshadowed by the lavish lifestyle he enjoyed for most of his life.<sup>164</sup> The U.S. has had one of the highest incarceration rates,<sup>165</sup> yet criminal prosecution is limited in fraud cases because of the challenges of identifying the true culprit, time, and

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<sup>162</sup> Jordan Reynolds, *9 Reasons Digital Fraud is On the Rise*, SEC. MAG. (Nov. 12, 2020), <https://www.securitymagazine.com/articles/93912-reasons-digital-fraud-is-on-the-rise> [<https://perma.cc/K5RB-Q7HN>] (“Then, they establish open bank accounts and cards, acting like legitimate customers. Once they’ve established strong credit scores, the fraudsters ask for higher credit limits or larger loans and simply stop paying. Synthetic identity fraud is damaging for consumers, but also expensive for lenders too, costing them \$6 billion annually. Fraudsters also leverage PII for account takeover. By using passwords and credentials obtained via data breaches or social engineering, they can gain control over accounts and make fraudulent online purchases. These transactions can be as minor as buying groceries on a debit card or as severe as using someone else’s account to take out a mortgage.”).

<sup>163</sup> An English Study found, that although the police received 277,561 reports of fraud in 2017-18, only 8,313 (three percent) led to criminal charges. This compares to thirteen percent of reported crimes overall that result in a charge, summons or other action. Miller, *supra* note 162.

<sup>164</sup> See Steve Fishman, *Bernie Madoff, Free at Last*, N.Y. MAG. (Jun. 4, 2010), <https://nymag.com/news/crimelaw/66468/> [<https://perma.cc/8PSB-T4E4>]. Ironically, Bernie lived a comfortable life behind bars. *Id.* Other inmates admired him and would often request financial advice. *Id.* He received a job in the prison’s commissary and had a wide social circle. *Id.* In interviews, Madoff would often remark how prison had left him with an opportunity to live free of the lie he had built. *Id.* Madoff also had access to a prison therapist, who he claims helped him realize that he was ultimately a good person led astray by his ego. See Alex Dobuzinkis, *Bernie Madoff Learns in Therapy He’s a “Good Person”*, REUTERS (Feb. 28, 2011, 10:35 PM), <https://www.reuters.com/article/usa-madoff-interview/bernie-madoff-learns-in-therapy-hes-a-good-person-idUSN2829274020110301> [<https://perma.cc/KD4R-Q4TQ>].

<sup>165</sup> Roy Walmsley, *World Prison Population List*, WORLD PRISON BRIEF (2018), [https://www.prisonstudies.org/sites/default/files/resources/downloads/wppl\\_12.pdf](https://www.prisonstudies.org/sites/default/files/resources/downloads/wppl_12.pdf) [<https://perma.cc/2RKL-L2U4>].



cost.<sup>166</sup> Additionally, multiple courts and commentators have discussed the challenges in proving fraud in civil cases, a demanding common law standard, which includes materiality, reliance, damages, and a clear and convincing standard of proof.<sup>167</sup> Furthermore, the critical information showing the deception is usually in the defendant's possession, where he can, like Madoff, deny its existence and present specious explanations until proven.<sup>168</sup>

Unlike a motion to dismiss under *Iqbal*, a summary judgment motion allows a fact to be debated with each side presenting proof, and at oral argument, each side is presented with challenging questions they must answer. Therefore, a proponent of summary judgment must lay out the facts and be questioned about that proffer.<sup>169</sup> In contrast, because the relevant question in an *Iqbal* motion is the sufficiency of the plaintiff's complaint and the underlying proofs, the culpable defendant faces few questions.<sup>170</sup> Instead, the defendant's lawyer may challenge the sufficiency or factual support for allegations that are, in fact, true. Essentially, the victim's complaint is on trial in an *Iqbal* motion.

This translates into the disposition of the claim through settlement. In essence, the defendant may boldly but accurately state to the fraud victim: "You will spend a lot of time pursuing this claim, it will cost you a lot of money, and your case will go nowhere." In such circumstances, the best-case result is a small payment covering only part of the loss incurred by the victims.<sup>171</sup> In this way, *Iqbal* deters fraud victims from bringing claims and pursuing justice because the cost-benefit analysis of bringing a civil claim is not strong enough.

Such inequities highlight the problem with the *Iqbal* standard. We punish those crimes that are easy to uncover and apprehend the culprit,

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<sup>166</sup> JM Olejarz, *Understanding White Collar Crime*, HARV. BUS. REV. ONLINE (Nov. 2016), <https://hbr.org/2016/11/understanding-white-collar-crime> [<https://perma.cc/LL2V-49A3>].

<sup>167</sup> J. Patrick Diener, *How to Prove Fraud*, BERESFORD BOOTH LAW'S (Mar. 9, 2023), <https://beresfordlaw.com/how-to-prove-fraud/#> [<https://perma.cc/9UMC-6E8E>].

<sup>168</sup> *Id.*

<sup>169</sup> Chloe Meltzer, *What Happens at a Motion for Summary Judgement Hearing?*, SOLOSUIT (Oct. 19, 2022), <https://www.solosuit.com/posts/happens-motion-summary-judgment-hearing#> [<https://perma.cc/V6C3-MDBP>].

<sup>170</sup> *See generally* Michalski, *supra* note 85.

<sup>171</sup> *See* Tom Hays & Larry Neumeister, *Even After Madoff's Death, Work to Unwind Epic Fraud Goes On*, AP NEWS (June 2, 2021, 10:41 AM), <https://apnews.com/article/bernie-madoff-fraud-investigation-295bbd961885caca88c5c7c76b7df297> [<https://perma.cc/L6QE-ZWTL>].

yet sophisticated schemes causing profound injury face lesser scrutiny. *Iqbal*'s burdensome pleading standard thus fails to prioritize the public's safety and the fraud victim's solicitude.

### **E. *Iqbal* Prevents Courts from Assisting Legislatures and Agencies to Catch Fraud**

Those engaged in deception frequently complain the most about the government's efforts to hold companies accountable and unveil fraud.<sup>172</sup> Madoff complained of the disruption caused by an "unnecessary" SEC investigation.<sup>173</sup> Several statutes reflect legislative concern about the dangers of coordinated illegal behavior.<sup>174</sup> Legislation such as the Dodd-Frank Act places substantial reporting and other requirements upon several businesses.<sup>175</sup> While these reporting requirements help hold companies accountable and can dissuade fraudulent schemes, companies find the requirements costly and burdensome and actively lobby the government to loosen its oversight.<sup>176</sup> Although the SEC is petitioning for a larger budget,<sup>177</sup>

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<sup>172</sup> See generally BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM* (2003).

<sup>173</sup> See SEC REPORT NO. OIG-509, *supra* note 7, at 114.

<sup>174</sup> See generally Daniel R. Fischel & Alan O. Sykes, *Civil RICO after Reves: An Economic Commentary*, 1993 SUP. CT. REV. 157 (1993); see also Pamela Bucy Pierson, *RICO, Corruption, and White-Collar Crime*, 85 TEMP. L. REV. 523, 539 (2013) ("Pursuing a routine white-collar case easily takes twenty times, even a hundred times, the investigative, pretrial, and trial time that a rape or burglary case may take.").

<sup>175</sup> See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Calls for legislation to hold Wall Street accountable led to the Wall Street Reform and Consumer Protection Act, better known as Dodd-Frank. See Samuel C. Leifer, *Protecting Whistleblower Protections in The Dodd-Frank Act*, 113 MICH. L. REV. 121, 128 (2014). Alongside sweeping reform to the SEC and other regulatory bodies, Dodd-Frank also provides avenues of support for whistleblowers. *Id.* These reforms are still imperfect, albeit much less so than they were before the fall of Madoff and the Lehman Brothers.

<sup>176</sup> Brian Slodysko et al., *Army of lobbyists worked to water down bank rules that regulated SVB and Signature: 'You couldn't throw an elbow without running into one'*, FORTUNE (Mar. 21, 2023, 5:48 AM), <https://fortune.com/2023/03/21/army-lobbyists-worked-water-down-bank-rules-regulated-svb-signature-dodd-frank/> [<https://perma.cc/V5W3-2BDE>].

<sup>177</sup> David Axelrod et al., *The SEC FY 2023 Budget Request Predicts Increased Enforcement Activities*, BALLARD SPAHR (Mar. 31, 2022), <https://www.ballardspahr.com/insights/alerts-and-articles/2022/03/the-sec-fy-2023-budget-request-predicts-increased-enforcement-activities> [<https://perma.cc/68SU-SGXF>].

there has been no indication that increasing the budget helps deter securities fraud schemes.<sup>178</sup> In short, political and financial forces affect the effectiveness of oversight and investigations led by Congress or federal administrative agencies.

As international fraud and complex internet schemes become increasingly common, courts can supplement legislative and administrative efforts to bring justice to victims of financial fraud. Many of these schemes, unfortunately, take very long to uncover due to savvy fraudsters covering their tracks. The revelation of the fraud in Madoff's case was presented on his terms after years of utilizing investor funds for a lavish lifestyle.<sup>179</sup> When investigations take years to reveal fraudulent schemes, they increase the scope of harm to victims and decrease their chances of recovering financial losses.<sup>180</sup> The court system should supplement Congress's oversight powers and the SEC's investigatory powers. However, the *Iqbal* standard dissuades fraud victims from pursuing these claims in civil court by setting a high bar for pleading a valid claim, thus preventing the judicial branch from using its powers to bring the truth to light and justice to victims.<sup>181</sup>

#### IV. CONCLUSION

When applied to fraud claims, the *Iqbal* standard does not meet the needs of justice. Instead, *Iqbal* presents unnecessary barriers to the victim and effectively protects many criminals engaged in fraudulent schemes. Such civil claims compensate victims, reveal frauds, protect the public, and deter deception – all important goals when the regulatory and criminal justice machinery cannot address complex financial fraud.

Furthermore, the notion that the Madoff investigation eliminated Ponzi schemes has been dispelled in recent years. Despite the vast publicity surrounding Madoff,<sup>182</sup> Ponzi schemes continue to thrive

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<sup>178</sup> See generally John C. Calhoun, *Looking for the Dog That Didn't Bark: Do Increased SEC Budgets Reduce Rates of Securities Fraud*, 41 VT. L. REV. 209 (2016) (examining how an increase in funding does not reduce securities crime).

<sup>179</sup> Dick Carozza, *Chasing Madoff*, FRAUD MAG. (May 2009), <https://www.fraud-magazine.com/article.aspx?id=313> [<https://perma.cc/6ESR-NGDP>].

<sup>180</sup> See *infra* Section II.D.

<sup>181</sup> See generally Robert Cooter & Winand Emons, *Truth-Revealing Mechanisms for Courts*, 159 J. INT'L AND THEORETICAL ECON., 259 (June 2003) (discussing how placing sanctions on witnesses for perjurious testimony helps lead to less slanted testimony which in turn allows the court to reveal the truth).

<sup>182</sup> Amy Haneline, *Bernie Madoff's Historic Ponzi Scheme Inspired Several Hollywood Projects*, USA TODAY, <https://www.usatoday.com/story/entertainme>

today. As international financial frauds become increasingly common, the constraints placed on the plaintiff by *Iqbal* have the potential to hamstring the plaintiff and ultimately fail to protect the public.<sup>183</sup> Failing to learn the lessons of Madoff will pave the way for new fraudsters to commit similar schemes.

The rise and fall of FTX in 2022 provides a compelling example of how a Madoff-like fraud could thrive almost two decades after Madoff revealed his scheme.<sup>184</sup> Led by crypto-wunderkind Sam Bankman-Fried, FTX was a well-regarded cryptocurrency exchange valued at \$32 billion.<sup>185</sup> Featured in many financial publications,<sup>186</sup> FTX even aired a Superbowl commercial featuring prominent actors and athletes.<sup>187</sup> However, Bankman-Fried would secure his legacy as the Madoff of the crypto era after allegedly losing billions in investor funds through a financial fraud similar to Madoff's scheme.<sup>188</sup>

One seeming lesson of Madoff's scheme was that Madoff could not be trusted since he essentially generated and verified his own statements. Second-generation Ponzi schemes arranged to have purported independent third parties verify information in customer statements. While Madoff generated his statements,<sup>189</sup> Bankman-Fried

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nt/tv/2021/04/14/bernie-madoff-how-watch-chasing-madoff-other-movies-he-inspired/7219787002/ [https://perma.cc/7YX9-2ELX] (last updated Apr. 14, 2021, 2:22 PM) (detailing five movies and documentaries focused on Madoff's life).

<sup>183</sup> Greg Iacurci, *Ponzi Schemes Hit Highest Level in Decade, Hinting Next 'Investor Massacre' May be Near*, CNBC, <https://www.cnbc.com/2020/02/11/ponzi-schemes-hit-the-highest-level-in-10-years.html> [https://perma.cc/FX5D-5Q4H] (last updated Feb. 25, 2020, 8:57 AM).

<sup>184</sup> See generally Amanda Hetler, *FTX scam explained: Everything you need to know*, TECHTARGET (Nov. 6, 2023), <https://www.techtarget.com/whatis/feature/FTX-scam-explained-Everything-you-need-to-know#:~:text=Sam%20Bankman%2DFried%20started%20FTX,an%20end%20in%20November%202022> [https://perma.cc/Y4X3-VQF6].

<sup>185</sup> Matt Egan, *FTX Crash is Eerily Similar to the Bernie Madoff Scandal, Ex-Regulator Sheila Bair Says*, CNN BUS., <https://www.cnn.com/2022/11/15/business/ftx-madoff-bankman-fried-bair/index.html> [https://perma.cc/4JJU-MUEL] (last updated Nov. 15, 2022).

<sup>186</sup> *Id.*

<sup>187</sup> Jack Schickler, *Larry David's Super Bowl Ad Casts Doubt on FTX. US Separation, DOJ Says*, COINDESK, <https://www.coindesk.com/policy/2023/09/04/larry-davids-superbowl-ad-casts-doubt-on-ftxus-separation-doj-says/> [https://perma.cc/494E-WSNC] (last updated Sept. 5, 2023, 11:38 AM).

<sup>188</sup> Goswami, *supra* note 32.

<sup>189</sup> See generally MARKOPOLOS, *supra* note 6.

went a step further by directing third parties to assure investors that their money was properly held.<sup>190</sup> Instead, Bankman-Fried misappropriated the funds from customers and FTX by siphoning them to a sister company called Alameda Research.<sup>191</sup> The stolen funds were purportedly used for personal purposes, celebrity endorsements, political contributions, and to cover trading losses.<sup>192</sup> Like Madoff, Bankman-Fried used “his pedigree and connections to seduce sophisticated investors and regulators into missing ‘red flags’ hiding in plain sight.”<sup>193</sup> When the scheme was eventually uncovered, the investigation revealed a multi-billion dollar gap, leading to a criminal prosecution<sup>194</sup> whereby he was ultimately convicted.<sup>195</sup>

In addition to FTX, several other Ponzi schemes have been uncovered in the crypto area.<sup>196</sup> In February 2022, the founder of a crypto trading company, Bitconnect, was indicted after allegedly absconding with \$2.4 billion from investors.<sup>197</sup> Yet another entity by the

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<sup>190</sup> See Eric Rosenberg, *Who is Sam Bankman-Fried?*, INVESTOPEDIA, <https://www.investopedia.com/who-is-sam-bankman-fried-6830274> [https://perma.cc/KV3G-98RX] (last updated Feb. 18, 2023). Sam Bankman-Fried rose to prominence as the head of one of the world’s largest cryptocurrency exchanges as the co-founder and former chief executive officer of FTX. *Id.*

<sup>191</sup> See Ken Sweet & Larry Neumeister, *Star Witness Carolien Ellison Says FTX Founder Sam Bankman-Fried Hoped to be US President Someday*, KCRA 3, <https://www.kcra.com/article/ftx-founder-sam-bankman-fried-hoped-to-be-president/45518902#> [https://perma.cc/8AG4-LTKM] (last updated Oct. 12, 2023).

<sup>192</sup> *Id.*

<sup>193</sup> Egan, *supra* note 187.

<sup>194</sup> See Kate Rooney & Jessi Joseph, *FTX Customers who Lost a Fortune on the Bankrupt Exchange are Doubling Down on Crypto*, CNBC, <https://www.cnbc.com/2023/10/02/ftx-customers-who-lost-fortune-are-doubling-down-on-crypto-.html> [https://perma.cc/UY4S-PPX4] (last updated Oct. 2, 2023).

<sup>195</sup> James Fanelli & Corinne Ramey, *Sam Bankman-Fried is Convicted of Fraud in FTX Collapse*, WALL ST. J., [https://www.wsj.com/finance/currencies/verdict-sam-bankman-fried-trial-ftx-guilty-4a54dbfe?mod=hp\\_lead\\_pos2](https://www.wsj.com/finance/currencies/verdict-sam-bankman-fried-trial-ftx-guilty-4a54dbfe?mod=hp_lead_pos2) [https://perma.cc/S2V5-NHBT] (last updated Nov. 2, 2023, 10:02 PM).

<sup>196</sup> See Robert Reich, *The Crypto Crash: All Ponzi Schemes Topple Eventually*, GUARDIAN (Jun. 19, 2022), <https://www.theguardian.com/technology/commentisfree/2022/jun/19/the-crypto-crash-all-ponzi-schemes-topple-eventually> [https://perma.cc/NY37-DANQ]. SEC Chairman Gary Gensler described cryptocurrency investments as “rife with fraud, scams, and abuse.” *Id.*

<sup>197</sup> Ramishah Manuf, *BitConnect Founder Charged with Orchestrating \$2 Billion Ponzi Scheme*, CNN BUS. (Feb. 27, 2022), <https://www.cnn.com/2022/02/27/bu>

name of OneCoin<sup>198</sup> purportedly defrauded \$4 billion from investors and subsequently pleaded guilty to wire fraud.<sup>199</sup> Ultimately, Ponzi schemes within the crypto industry are a serious problem. A fundamental concern is whether early civil claims could survive the scrutiny of *Iqbal*, and in an area with limited information, whether the plaintiff who correctly identifies a scheme has access to the necessary processes and tools to prove it in court.<sup>200</sup>

The F.R.C.P. Rule 9's heightened pleading standard shows the civil court system's recognition that fraud claims require specialized rules due to their unique nature. Whatever its general merits, *Iqbal* is misplaced when applied to civil fraud cases. The lessons of Madoff are that schemers are creative and persuasive and that substantial time and verification are usually required to uncover them. The SEC's report, emphasizing the need to examine and verify the facts, lays a sensible roadmap for investigating frauds and shows the need to use tools that *Iqbal* frequently precludes. Once Madoff was revealed to have self-generated fraudulent statements, other Ponzi schemers switched to an outside verification process whereby they controlled the verification process and could access funds despite what was represented to investors. Civil court claims are an important tool to detect fraud, and we need to empower victims with investigatory tools to match the creativity of the culprits.

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siness/bitconnect-ponzi-scheme-satish-kumbhani/index.html  
[https://perma.cc/FL66-WGB4].

<sup>198</sup> *Cryptoqueen: How this woman scammed the world, then vanished*, BBC NEWS (Nov. 24, 2019), <https://www.bbc.com/news/stories-50435014> [https://perma.cc/297P-KQ63]. Dr. Ruja Ignatova announced the launch of OneCoin in 2016. *Id.* Ignatova pitched OneCoin as a “Bitcoin killer,” which required investment capital to get off the ground. *Id.* However, OneCoin never launched; Ignatova pocketed her investment earnings and abandoned the venture. *Id.* The “Crypto Queen” has disappeared, despite attempts by authorities to locate her. *Id.*

<sup>199</sup> Luc Cohen, *U.S. Adds ‘Cryptoqueen’ to Most-Wanted List over Alleged \$4 Billion Fraud*, REUTERS, <https://www.reuters.com/world/us/us-adds-cryptoqueen-most-wanted-list-over-alleged-4-billion-fraud-2022-06-30/> [https://perma.cc/H225-PNC8] (last updated June 20, 2022).

<sup>200</sup> Jesse Coghlan, *800 Victims of Massive Bitconnect Fraud to Receive \$17M Restitution*, COIN TELEGRAPH (Jan. 13, 2023), <https://cointelegraph.com/news/800-victims-of-massive-bitconnect-fraud-to-receive-17m-restitution> [https://perma.cc/UV5D-VVHB].