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## Righting Others' Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds

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## Righting Others' Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds

### Disciplines

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# ARTICLES

## Righting Others' Wrongs

### A CRITICAL LOOK AT CLAWBACKS IN MADOFF- TYPE PONZI SCHEMES AND OTHER FRAUDS

*Amy J. Sepinwall*<sup>†</sup>

#### INTRODUCTION

We typically expect wrongdoers to redress the victims of their transgressions.<sup>1</sup> But do those who innocently benefit from wrongdoing owe restitution to the victims of the wrong? Irving Picard, the trustee who has been charged with recovering and distributing money to the victims of Bernie Madoff's Ponzi scheme, obviously thinks so.<sup>2</sup> Picard has filed over one

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<sup>1</sup> See, e.g., 1 FRANCIS HILLIARD, *THE LAW OF TORTS OR PRIVATE WRONGS* 82 (1859) ("The liability to make reparation for an injury rests upon an original moral duty, enjoined upon every person, so to conduct himself or exercise his own rights as not to injure another." (citation omitted) (emphasis omitted)); John C.P. Goldberg, *The Constitutional Status of Tort Law: Due Process and the Right to a Law for the Redress of Wrongs*, 115 *YALE L.J.* 524, 541-44 (2005) (describing the goal of tort law as seeking redress for private harm). For a searching review of the ways in which federal agencies have acted to compel disgorgement from wrongdoers and, in some cases, have then sought to return ill-gotten gains to the wrongdoers' victims, see generally Adam S. Zimmerman, *Distributing Justice*, 86 *N.Y.U. L. REV.* 500 (2011).

<sup>2</sup> See *infra* notes 119-120 and accompanying text. The Securities and Exchange Commission (SEC) defines a Ponzi scheme as "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by

thousand clawback suits,<sup>3</sup> seeking to recover any money “winning investors” realized in excess of their investment and to return this money to the Madoff “losers,”<sup>4</sup>—i.e., those who lost some or all of their principal when the Ponzi scheme went bust.<sup>5</sup> Kenneth Feinberg, former Special Master for the September 11 Victims Compensation Fund,<sup>6</sup> therefore quips that the Madoff clawback suits have Picard “taking from Peter to pay Paul.”<sup>7</sup> Importantly, the “Peters” in these suits include entities or individuals who are believed to have been innocent of any wrongdoing—there is no allegation that they knew or should have known of the fraud.<sup>8</sup> Thus, the Madoff case provides

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new investors.” SEC, *Ponzi Schemes—Frequently Asked Questions*, <http://www.sec.gov/answers/ponzi.htm> (last visited Nov. 1, 2012).

<sup>3</sup> *Times Topics: Irving H. Picard*, N.Y. TIMES, [http://topics.nytimes.com/topics/reference/timestopics/people/p/irving\\_h\\_picard/index.html](http://topics.nytimes.com/topics/reference/timestopics/people/p/irving_h_picard/index.html) (last updated June 25, 2012); see also Lisa Sandler & Bob Van Voris, *Madoff Trustee Defends “Clawbacks” in U.S. District Court*, BLOOMBERG (Aug. 23, 2011, 9:10 AM), <http://www.bloomberg.com/news/2011-08-23/madoff-trustee-defends-1-6-million-clawback-suit-in-u-s-district-court.html>.

<sup>4</sup> I follow the bankruptcy trustee in referring to those who had withdrawn amounts equal to or greater than their principal investment as “winners,” and to those who had not yet recovered all—or perhaps even any—of their principal when the scheme collapsed as “losers.” Nonetheless, I note that this is a tendentious way of describing the two categories of investors, since it implies that there is something undeserved about the money the “winners” obtained. See Clarence L. Pozza, Jr., et al., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113, 117 (2010) (“Ponzi scheme investors [ . . . ] are often regrettably characterized as ‘winners’ and ‘losers.’ This dichotomy tends to prejudice the equitable collection of funds and distribution to Ponzi victims.”) (citation omitted).

<sup>5</sup> See, e.g., David Ellis, *Madoff Investors May Have To Cough up Profits*, CNNMONEY (July 26, 2010, 10:52 AM), [http://money.cnn.com/2010/07/26/news/companies/madoff\\_investors/index.htm](http://money.cnn.com/2010/07/26/news/companies/madoff_investors/index.htm); Ashby Jones, *Madoff “Winners” Beware: Irv Picard Hasn’t Gone Away*, WSJ LAW BLOG (July 26, 2010, 9:14 AM), <http://blogs.wsj.com/law/2010/07/26/madoff-winners-youre-forewarned-irv-picard-hasnt-gone-away/>.

<sup>6</sup> See, e.g., Margaret L. Shaw, *Madoff Victim Compensation: Interview with Ken Feinberg*, 16 DISP. RESOL. MAG., Winter 2010, at 11. Kenneth Feinberg has also overseen compensation funds for victims of the Virginia Tech shootings, the BP oil spill, and Holocaust reparations. See generally FEINBERG ROZEN, LLP, <http://www.feinbergrozen.com/> (last visited Oct. 1, 2012).

<sup>7</sup> See Shaw, *supra* note 6, at 11.

<sup>8</sup> I rely here on a standard definition of fraud. See, e.g., BLACK’S LAW DICTIONARY FREE ONLINE (2d ed.), <http://thelawdictionary.org/fraud/> (last visited Sept. 7, 2012) (“Fraud consists of some deceitful practice or willful device, resorted to with intent to deprive another of his right, or in some manner to do him an injury.”). While many of those who have been targeted for clawbacks are innocent of the fraud, see, e.g., Richard Sandomir, *Actions of Madoff Victims’ Trustee Will Be Reviewed*, N.Y. TIMES, July 28, 2011, at B15, Picard alleges that many others knew or should have known. Most prominent among those whom the trustee accuses of having known about, or else been willfully blind to, the scheme, are Fred Wilpon and Saul Katz, real estate moguls and part owners of the New York Mets, who had invested their company’s revenues with Madoff. See, e.g., Jeffrey Toobin, *Madoff’s Curveball: Will Fred Wilpon Be Forced to Sell the Mets?* NEW YORKER (May 30, 2011), [http://www.newyorker.com/reporting/2011/05/30/110530fa\\_fact\\_toobin?printable=true&currentPage=all](http://www.newyorker.com/reporting/2011/05/30/110530fa_fact_toobin?printable=true&currentPage=all); Bob Van Voris, *Madoff Trustee May Do What Bernie Didn’t: Give Victims Profit*, BLOOMBERG (Feb. 11, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-02-11/madoff-trustee-may-do->

an opportunity to explore the grounds and bounds of restitution as between the innocent beneficiaries and victims of a wrong.

We shall see that the questions of whether, when, and why innocent winners in a financial fraud should be compelled to retribute the fraud's losers is both underserved by existing doctrine<sup>9</sup> and understudied by scholars.<sup>10</sup> Perhaps nowhere is

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something-bernie-never-did-give-victims-real-profit.html. The company used its Madoff accounts as a kind of bank, depositing money until it was needed for payroll or other expenses, withdrawing the needed funds, and then beginning the cycle anew. Toobin, *supra*; see also Richard Sandomir, *Trustee Says Mets Saw Madoff as House Money*, N.Y. TIMES, Feb. 21, 2012, at B11. Over the years, Wilpon's company deposited roughly \$700 million, and withdrew roughly \$1 billion (the \$300 million in excess of the company's deposits was taken to constitute profits on the investment). See, e.g., Holman W. Jenkins, Jr., *Madoff and the Mets: How the "Extremely Wealthy" Allowed the Madoff Fraud to Endure*, WALL ST. J. (BUSINESS WORLD) (Feb. 8, 2011, 9:12 PM), <http://online.wsj.com/article/SB10001424052748704364004576132201926195.html>.

Picard filed a lawsuit against Wilpon and his partners, seeking to claw back the \$1 billion in withdrawals the firm had made from its Madoff accounts over the years. See, e.g., Michael O'Keefe, *Feds To Investigate Irving Picard's "Clawback" Suits To See if Madoff Ponzi Scheme Victims Are Hurt*, N.Y. DAILY NEWS (July 28, 2011, 4:00 AM), [http://articles.nydailynews.com/2011-07-28/sports/29840581\\_1\\_madoff-trustee-wilpon-and-katz-amanda-remus](http://articles.nydailynews.com/2011-07-28/sports/29840581_1_madoff-trustee-wilpon-and-katz-amanda-remus). The trustee maintains that the defendants did know, or should have known, about the Ponzi scheme, while the defendants vehemently contest these allegations, calling the claims against them "abusive, unfair[,] and untrue," Bob Van Voris, *Madoff Trustee May Do What Bernie Didn't: Give Victims Profit*, BLOOMBERG (Feb. 11, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-02-11/madoff-trustee-may-do-something-bernie-never-did-give-victims-real-profit.html>. Madoff himself insists upon Wilpon and Katz's innocence: "Fred was not at all stock market savvy and Saul was not really either. They were strictly Real Estate people. Although I explained the Strategy to them they were not sophisticated enough to evaluate it properly." See Toobin, *supra* note 8, at 15 (internal quotation marks omitted). In a series of rulings, Judge Jed Rakoff reduced the maximum amount of recovery from the defendants to \$384 million. See, e.g., Adam Rubin, *Mets Owners Must Pay, Go to Trial*, ESPNNEWYORK.COM (Mar. 6, 2012), [http://espn.go.com/new-york/mlb/story/\\_id/7647107/judge-new-york-mets-owners-pay-much-83m-trial-decide-303m](http://espn.go.com/new-york/mlb/story/_id/7647107/judge-new-york-mets-owners-pay-much-83m-trial-decide-303m). On March 16, 2012, Wilpon and partners entered into a settlement agreement with Picard under which they agreed to pay \$162 million to the trustee. See, e.g., Richard Sandomir & Ken Belson, *Mets' Owners Agree to Settle Madoff Suit for \$162 Million*, N.Y. TIMES, Mar. 19, 2012, at A1, available at [http://www.nytimes.com/2012/03/20/sports/baseball/mets-owners-pay-162-million-to-settle-madoff-suit.html?\\_r=1&pagewanted=print](http://www.nytimes.com/2012/03/20/sports/baseball/mets-owners-pay-162-million-to-settle-madoff-suit.html?_r=1&pagewanted=print).

<sup>9</sup> General restitutionary doctrine has long been charged with inattention and incoherence. See, e.g., Chaim Saiman, *Restitution and the Production of Legal Doctrine*, 65 WASH. & LEE L. REV. 993, 994 (2008) ("[I]n American legal discourse restitution sits at the backwaters of the academic and judicial consciousness . . ."); Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265, 267 (1998) ("Most law schools gave up teaching restitution a generation ago, and many judges and practitioners are not familiar with its general principles. Lack of familiarity with the restitutionary elements of the background rules results in a predictable distortion of commercial law."). Cf. PETER BIRKS, UNJUST ENRICHMENT 40 (2005) (noting that novel fact patterns pose problems for the doctrine of unjust enrichment, since there isn't a general, one-size-fits-all principle for determining when one party has innocently benefitted *at the expense of* another). See generally Mallory A. Sullivan, Note, *When the Bezzle Bursts: Restitutionary Distribution of Assets After Ponzi Schemes Enter Bankruptcy*, 68 WASH. & LEE L. REV.

this inattention more apparent, and potentially disquieting, than in the efforts to require innocent Ponzi scheme winners to defray the losses of the scheme's losers. As courts have noted, the provisions governing the efforts to recover money for investors in a Ponzi scheme stand "at the intersection of two important national legislative policies on a collision course—the policies of bankruptcy and securities law."<sup>11</sup> Neither of these bodies of law was designed with the other in mind,<sup>12</sup> and there is much that remains unsettled in determining the appropriate interaction between the two.<sup>13</sup>

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1589, 1598-99 (2011) (describing the general confusion around restitution, especially in the context of a bankruptcy).

<sup>10</sup> Cf. BIRKS, *supra* note 9, at 3 ("Of the subjects which form the indispensable foundation of private law, unjust enrichment is the only one to have evaded the great rationalization achieved by the writers of the textbooks since the middle of the 19th Century in England and America.").

<sup>11</sup> Picard v. Katz, 462 B.R. 447, 451 (S.D.N.Y. 2011) (quoting *In re Enron Creditors Recovery Corp.*, 651 F.3d 329, 334 (2d Cir. June 28, 2011) (citation omitted)); see also Katz, 462 B.R. at 450 (noting that the clawback lawsuit against Wilpon and his partners "raises important and in some respects unsettled issues of the interaction of securities law with bankruptcy law"). Cf. Hanoch Dagan, *Restitution in Bankruptcy: Why All Involuntary Creditors Should Be Preferred*, 78 AM. BANKR. L.J. 247, 247-48 (2004) (discussing the untoward interaction of restitution and bankruptcy law).

<sup>12</sup> See, e.g., Clarence L. Pozza, Jr., et al., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113, 131 (2010) ("The legal principles often utilized in the Ponzi scheme cases were not originally developed to address Ponzi scheme victim fairness issues and create somewhat extreme arguments and results."). Cf. Kull, *supra* note 9, at 265-66 ("The contemporary treatment of restitution in bankruptcy has become confused and haphazard because the subject is not addressed by the Bankruptcy Code."); Peter J. Henning, *The Roller Coaster Ride Continues for Madoff Investors*, N.Y. TIMES (DEALBOOK) (Oct. 3, 2011, 3:26 PM), <http://dealbook.nytimes.com/2011/10/03/the-roller-coaster-ride-for-madoff-investors-continues/> ("Investors in Mr. Madoff's Ponzi scheme have been whipped back and forth as the courts try to apply the law to a case that is unprecedented in many ways.").

<sup>13</sup> See, e.g., Kathy Bazoian Phelps, Partner, Danning, Gill, Diamond & Kollitz L.L.P., *Fraudulent Transfer Claims and Defenses in Ponzi Schemes*, Address Before the Southwest Bankruptcy Conference (2009), available at <http://www.abiworld.org/committees/newsletters/litigation/vol6num5/ponzi.pdf> (last visited on Sept. 24, 2012) ("[C]ourts are continuing to refine the rules which arise in unwinding these tangled financial webs. In particular, the law regarding fraudulent transfer claims to recover funds paid by the Ponzi debtor to investors as a return of principal or payment of fictitious profits and defenses which can be asserted to those claims continue to evolve."); Joshua Marcus & Jake Greenberg, *Ponzi Schemes: Washed Ashore by Recession's Low Tide, Reveal Controversial Issues*, 29 AM. BANKR. INST. J., Oct. 2010, at 48, 107 ("Ponzi schemes—one of the horrible byproducts unearthed by the financial crisis—have raised noteworthy and contentious bankruptcy issues."). Cf. Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28 AM. BANKR. INST. J., Apr. 2009, at 16, 80 ("[P]ursuing investors who lacked diligence in Madoff will unnecessarily cost hundreds of millions."); Jeff Benjamin, *Madoff Investors May Face Clawbacks*, INVESTMENT NEWS (Feb. 10, 2009), <http://www.investmentnews.com/article20090210/REG/902109979> (quoting an attorney involved in the Madoff clawback cases, who predicts that, given the unsettled questions of law, "[t]he [civil litigation] will spawn a whole industry for the next decade.").

Even more concerning, few commentators have given thought to whether the recovery provisions of bankruptcy law *ought* to extend to the innocent beneficiaries of a financial fraud. This is especially troubling because no legal mechanism exists to permit recovery from investors who innocently profited from a financial fraud *where the fraud does not result in the entity's bankruptcy*. In this way, Ponzi scheme winners incur harsher treatment than those who innocently profit from other kinds of financial fraud, although case law and commentaries do not offer a justification for this inconsistent treatment. In particular, outside of the doctrine of unjust enrichment—which, I argue, is inapposite here—we lack a theory that elucidates why, and if so when, innocent beneficiaries of a transgression owe restitution to the transgression's victims. A central task of this Article is to provide such a theory, which can usefully be applied not just to Ponzi scheme cases but to other cases of financial wrongdoing as well—a prospect made all the more pressing in the wake of the financial meltdown.

More specifically, I examine attempts to extend the recovery provisions of bankruptcy law to the innocent beneficiaries of a Ponzi scheme and, after an analysis of the history and structure of the relevant statutes, I argue that these attempts problematically deviate from the recovery provisions' purpose. I then seek to establish that innocent winners in a Ponzi scheme are unlike the innocent beneficiaries of ill-gotten gains or good faith purchasers of stolen goods, and instead are more akin to investors who innocently profit from corporate or financial wrongdoing. Yet, so long as the offending corporations or brokerage firms do not end up bankrupt, the innocent investors who earned profits as a result of the wrongful conduct will be permitted to retain their “winnings.” I contend that if we do not seek to *claw back* profits from these innocent investors, then we should not seek to *claw back* profits from the

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It may be worth noting that there is a prior question as to whether bankruptcy law should apply at all in the wake of a Ponzi scheme, given that criminal forfeiture exists as a viable alternative. Supporters of criminal forfeiture argue that it would be less costly, thereby leaving more money to be distributed to the fraud's victims, and more compelling, given its retributive rationale. *See generally* Marcus & Greenberg, *supra*. Bankruptcy looks nonetheless to remain a preferred avenue for restituting the victims of a financial fraud, not least of all because it allows the estate to recover assets beyond those of the fraud's perpetrator—of particular relevance here, those of innocent winning investors. *Cf.* Paul W. Bonapfel et al., *Bankruptcy Court v. Federal Equity Receivership*, 26 EMORY BANKR. DEV. J. 207, 212-13 (2010).

innocent Ponzi scheme winners, either.<sup>14</sup> That contention, of course, could cut in two diametrically opposed directions—one could argue that we should allow the losses to lie where they fell or, by contrast, that we should implement restitution on a far wider scale than the law currently allows. I end by seeking to defend the latter alternative and by suggesting measures through which it could be implemented.

It is surprising that scholars have largely overlooked clawback suits in the context of a Ponzi scheme, given the troubling uncertainty and evident tensions they involve,<sup>15</sup> as well as the dramatic rise in their use. While the first set of clawback cases eventuating from a Ponzi scheme arose in the wake of Charles Ponzi's now infamous fraud<sup>16</sup> during the 1920s,<sup>17</sup> it was only in the 1980s that the use of a clawback suit to recover money from an *innocent* investor became widespread; in fact, 149 of the 190 published state and federal cases were decided in or after the year 2000.<sup>18</sup> Further, commentators predict that these suits will become even more common in the coming years.<sup>19</sup>

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<sup>14</sup> The migration of the noun “clawback” to the verb form “claw back,” appears to have gained currency in the 1980s, in light of efforts to enforce anti-trust provisions extraterritorially, and a resulting response permitting the defendant to recoup—i.e., claw back—damages imposed on him. *See, e.g., Note, Extraterritorial Application of the Export Administration Act of 1979 Under International and American Law*, 81 MICH. L. REV. 1308, 1318 n.58 (1983) (“[A] number of foreign states have enacted ‘blocking’ or ‘clawback’ statutes designed to protect their citizens from assertions of extraterritorial jurisdiction by the United States.”); *Note, Predictability and Comity: Toward Common Principles of Extraterritorial Jurisdiction*, 98 HARV. L. REV. 1310, 1311 n.6 (1985) (“Clawback statutes, such as § 6 of the British Protection of Trading Interests Act, 1980, ch. 11, follow from the premise that certain foreign judgments will not be given extraterritorial effect. . . . Once such a statute is invoked, the foreign defendant will be allowed to ‘claw back’ the punitive portion of the judgment (for example, two-thirds of a treble-damages antitrust award).” (citations omitted)).

<sup>15</sup> *Cf. Miriam A. Cherry & Jarrod Wong, Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 411 (2009) (noting that the term clawback “has been subject to neither rigorous analytical scrutiny nor definition and exposition”); Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 15 (2010) (observing that clawback provisions were “essentially unknown” before Sarbanes-Oxley).

<sup>16</sup> *Cunningham v. Brown*, 265 U.S. 1, 7-9 (1924) (discussing the collapse of Charles Ponzi's fraudulent investment program).

<sup>17</sup> Ponzi's scheme gave rise to eleven published opinions, two in state courts and the remainder in federal court, including two that went to the Supreme Court: *Ponzi v. Fessenden*, 258 U.S. 254 (1922), and *Cunningham*, *supra* note 16.

<sup>18</sup> *See infra* notes 86 and 87 and accompanying text (describing the evolution of the law on this score).

<sup>19</sup> *See, e.g., Michael C. Macchiarola, In the Shadow of the Omnipresent Claw: A Response to Professors Cherry and Wong*, MINN. L. REV. HEADNOTES (2011), [http://www.minnesotalawreview.org/headnotes/in-the-shadow-of-the-omnipresent-claw-in-response-to-professors-cherry-wong-2/#\\_ftn9](http://www.minnesotalawreview.org/headnotes/in-the-shadow-of-the-omnipresent-claw-in-response-to-professors-cherry-wong-2/#_ftn9) (“As the American economy continues to totter against an ever-growing populist momentum, it seems likely that clawback mechanisms of various sorts will be put to increasing use in the coming months and years.”).



To be sure, the Madoff scandal itself has garnered significant media and scholarly attention. Much of this has focused on the factors that facilitated the scheme—Madoff's exploitation of the affinity bonds he shared with many of his victims,<sup>20</sup> his proclaimed split-strike strategy,<sup>21</sup> and the SEC's failure to detect the fraud.<sup>22</sup> Other work has either addressed alternative enforcement regimes in the case of a Madoff-type fraud<sup>23</sup> or revisited white-collar crime sentencing policies<sup>24</sup> in light of Madoff's 150-year prison sentence,<sup>25</sup> which is likely to be the longest sentence ever imposed for a violation of an antifraud law.<sup>26</sup>

The handful of scholars who have addressed the use of clawback suits against innocent investors in Ponzi scheme cases have largely agreed that the suits are permissible in principle, and possibly even worthwhile.<sup>27</sup> Existing critical commentary tends to take issue only with the ways the suits are wielded in practice. Thus, scholars have objected to judicial interpretations of the doctrine;<sup>28</sup> the ad hoc development of the law, which threatens uniformity and predictability;<sup>29</sup> the opportunity for abuse of discretion that the suits allegedly

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<sup>20</sup> See, e.g., Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 957 (2009); Paul Krugman, *Madoff Explains Everything*, N.Y. TIMES (Nov. 17, 2011, 4:24 PM), <http://krugman.blogs.nytimes.com/2011/11/17/madoff-explains-everything> (“The Madoff affair, as you may know, was a classic case of ‘affinity fraud.’”).

<sup>21</sup> See, e.g., Carole Bernard & Phelim Boyle, *Mr. Madoff's Amazing Returns: An Analysis of the Split-Strike Conversion Strategy*, 17 J. DERIVATIVES 62, 62 (2009).

<sup>22</sup> See, e.g., Donald Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICH. ST. L. REV. 899, 900 (2009).

<sup>23</sup> See, e.g., Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010); Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463, 467 (2011).

<sup>24</sup> See, e.g., Daniel V. Dooley, Sr. & Mark Radke, *Does Severe Punishment Deter Financial Crimes?*, 4 CHARLESTON L. REV. 619, 622 (2010); Derick R. Vollrath, Note, *Losing the Loss Calculation: Toward A More Just Sentencing Regime in White-Collar Criminal Cases*, 59 DUKE L.J. 1001, 1004 (2010).

<sup>25</sup> Transcript of Sentencing Hearing at 49, *United States v. Madoff*, 626 F. Supp. 2d. 420 (S.D.N.Y. June 17, 2009) (No. 09 Crim. 213 (DC)).

<sup>26</sup> Peter J. Henning, *The Limits of Bigger Penalties in Fighting Financial Crime*, N.Y. TIMES (DEALBOOK) (Dec. 12, 2011, 4:03 PM), <http://dealbook.nytimes.com/2011/12/12/the-limits-of-bigger-penalties-in-fighting-financial-crime>.

<sup>27</sup> See, e.g., Cherry & Wong, *supra* note 15, at 397.

<sup>28</sup> The most common line of criticism on this score takes issue with what is taken to be an overly demanding standard of good faith, and an overly draconian set of consequences if one is shown to have lacked good faith, including compelled return of any money one withdrew from the scheme, whether as “profits” or principal. See, e.g., Sullivan, *supra* note 9, at 1615-23.

<sup>29</sup> See, e.g., Pozza et al., *supra* note 12, at 131 (“The current case-by-case approach does not appear to yield fair uniform results. A new comprehensive approach designed for overall victim fairness should be considered.”); Sullivan, *supra* note 9, at 1632; Macchiarola, *supra* note 19, *Conclusion* (text accompanying notes 67-68).

afford;<sup>30</sup> or the negative consequences that the suits are believed to produce among investors.<sup>31</sup> But there has been no sustained inquiry into the foundational normative question—namely, whether innocent winning investors *should* be required to help defray losing investors' losses in the first place.<sup>32</sup> This Article addresses that question and concludes that clawback suits targeting blameless winners lack a compelling legal or equitable basis.

The Article first proceeds, in Part I, by offering some of the factual and legal background to the Madoff case. In Part II, I turn to the legislative history and statutory structure of the Bankruptcy Code's recovery provisions, and I argue that there is only a weak doctrinal basis for the bankruptcy trustee's clawback efforts. Nonetheless, analogies to widely embraced rules surrounding unjust enrichment and stolen goods provide considerable intuitive support for the notion that Ponzi scheme winners should return some of their gains to the scheme's losers. For example, where an individual gains as a result of a wrong perpetrated against another—at that victim's expense—

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<sup>30</sup> Of particular note here is a concern that the trustee can use the threat of protracted, costly litigation to leverage settlements from investors who may have been wholly innocent of the fraud. *See, e.g.*, Sullivan, *supra* note 9, at 1629-30. *Cf.* Voris, *supra* note 8 (quoting Wilpon and Katz's complaint that the lawsuit against them is nothing more than "an outrageous strong-arm effort to try to force a settlement by threatening to ruin our reputations and businesses" (internal quotation marks omitted)).

<sup>31</sup> Thus, for example, Karen Nelson argues that the clawback suits create infighting between the scheme's investors, and encourage attorneys, in contravention of legal ethics, to advise their Madoff-investing clients to secret away their assets. *See* Karen E. Nelson, Note, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1473, 1457-58 (2011). Nelson also argues that clawing back money from innocent investors "strays from America's fundamental tenets of capitalism." *Id.* at 1458. I set this last concern aside because our political and economic culture is replete with instances in which individuals or entities help to defray losses that they have neither culpably caused, nor caused at all. Take, for example, the September 11th compensation fund, or our progressive system of taxation, for that matter. I go on to argue for a compensation program *more* expansive than the one entailed by the clawback suits, on the thought that there is usually nothing but luck that distinguishes those who profit from the stock market from those who do not. Luck should not play so great a role in determining whether one ends up on the losing end of a wrong. If capitalism cannot accommodate that thought, so much the worse for capitalism.

Mallory Sullivan complains that the clawback suits are unfair because they target investors who may have relied reasonably on the legitimacy of their withdrawals, and so no longer have the money now sought to be clawed back. *See* Sullivan, *supra* note 9, at 1633-34. Reasonable reliance seems to be the rationale underlying legislative proposals to limit, if not eliminate, clawback suits against innocent Ponzi scheme investors. *See* Sullivan, *supra* note 9, at 1633-34.

<sup>32</sup> *But cf.* O'Keefe, *supra* note 8 (describing a pending GAO investigation into Picard's recovery efforts, including his clawback suits, in response to a letter from several Congresspersons expressing concern about the trustee's "punishing the Ponzi scheme scammer's victims by filing 'clawback' lawsuits") (quoting Rep. Scott Garret (R-N.J.)).

the individual may be compelled to return these ill-gotten gains. Similarly, where an individual purchases an item without knowledge that it is stolen, she must return the stolen item to its original owner, even if that means the innocent purchaser will forfeit the money she paid to the seller. Pursuant to this reasoning, the Madoff bankruptcy trustee has sought to defend the clawback actions by analogizing them to cases seeking the disgorgement of ill-gotten gains or the return of stolen goods. In Part III, I argue that these analogies are mistaken, because the Madoff winners are neither the beneficiaries of a windfall—as is typically true in cases of unjust enrichment—nor the recipients of a unique, non-fungible good, as is typically true in cases of stolen goods. In Part IV, I examine other doctrines that appear to impose pecuniary penalties on investors who innocently profit from corporate or financial wrongdoing, but I argue that their apparent resemblance is deceiving. These doctrines either extend only to investors who are not wholly innocent of the wrongdoing or do not in fact require the innocent investor to *return* money as a means of offering restitution. Together, Parts II, III, and IV seek to establish that we cannot find support for the Ponzi scheme clawback actions in the bankruptcy code, or within other equitable or legal doctrines. Nevertheless, rather than abandoning the prospect of restitution altogether, I seek, in Part V, to defend a restitutionary scheme that would have *all* those who profit in the market defray the losses that fraudulent schemes produce. In other words, I argue that “winning” investors bear restitutionary obligations whether their profits derive from a legitimate or fraudulent investment vehicle. I thus end by urging a far more expansive restitutionary program than clawback suits currently afford.

## I. FACTUAL AND LEGAL BACKGROUND

The Madoff scandal is a good place to begin an investigation into Ponzi scheme clawback cases—not only because it is the largest fraud in recorded history, but also because it provides an entrée to the legal framework governing clawback suits and the murky, ad hoc, and oftentimes flawed judicial reasoning that these suits invite. In Part I.A, I provide a brief overview of the relevant facts leading up to Madoff’s arrest and the commencement of the recovery actions. Part I.B engages critically with the Second Circuit opinion that set the stage for the clawback suits by denying the Madoff winners’

claims to recover what they believed they were owed based on their last investment account statements.

A. *History and Revelation of a Fraud*

Madoff created Bernard L. Madoff Investment Securities (BLMIS) in the early 1960s,<sup>33</sup> originally functioning as a market-maker and broker-dealer.<sup>34</sup> Later, Madoff added an investment advisory arm to the business, which Madoff used to recruit investors for his eventual Ponzi scheme.<sup>35</sup> Although Madoff, in the course of his confession, reported that the Ponzi scheme began in the early 1990s,<sup>36</sup> one of his associates has since revealed that the scheme in fact dated back to the early 1970s.<sup>37</sup> It is not clear how much of Madoff's business was fraudulent in the period between the 1970s and the 1990s. But we do know that beginning in the 1990s, Madoff did not buy or sell a single share on behalf of his customers, despite sending investors regular statements that reported market transactions and indicated an average growth of 12 percent.<sup>38</sup> Madoff claimed that his consistent positive returns resulted from a unique split-strike conversion strategy that he had pioneered.<sup>39</sup>

Because Madoff made no investments, customer redemptions were funded with money that other customers had deposited with him. Thus, when a customer sought to withdraw money from her account in an amount listed on her most recent statement, Madoff made up the difference between the amount the customer had invested and the amount she sought to withdraw with money other customers had "invested" with him.<sup>40</sup>

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<sup>33</sup> Complaint at 4, Sec. & Exch. Comm'n v. Madoff, 2009 WL 980288 (S.D.N.Y. Apr. 10, 2009) (No. 08-CV-10791).

<sup>34</sup> See, e.g., Martin P. Randisi & Joseph Koletar, *A CAT Scan of the Madoff Scandal: Diagnosing Fraud Inside The Black Box*, HOLTZ RUBENSTEIN REMINICK LLP, at 4, available at <http://www.hrcpa.com/Catscan.pdf> (last visited Sept. 24, 2012).

<sup>35</sup> See, e.g., Plea Allocation of Bernard L. Madoff, at \*2, \*4, available at <http://online.wsj.com/public/resources/documents/20090315madoffall.pdf> (last visited Sept. 24, 2012).

<sup>36</sup> *Id.* at \*2.

<sup>37</sup> See *Madoff Associate Says Fraud Went Back to '70s*, N.Y. TIMES, Nov. 21, 2011, at B4.

<sup>38</sup> See Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 363, 371-72 (2009). Rhee here describes the difficulty that a typical investor would have faced in seeking to establish that these returns were impossible.

<sup>39</sup> "The split-strike conversion strategy supposedly involved buying a basket of stocks listed on the Standard & Poor's 100 Index and hedging through the use of options." *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 231 (2d Cir. 2011).

<sup>40</sup> See Plea Allocation of Bernard L. Madoff, *supra* note 35, at \*1.

Importantly, many of those who withdrew more money from their Madoff accounts than their principal investments were genuinely in the dark about his fraud. For one thing, we now know that Madoff was masterful when it came to hiding his fraud. He maintained an aloof posture, often refusing a prospective investor before “accepting” her business;<sup>41</sup> his returns were consistent but also relatively modest so as not to arouse suspicion;<sup>42</sup> and the purported split-strike conversion strategy was a seemingly plausible vehicle for generating these steady, yet unspectacular returns.<sup>43</sup> Further, a securities investor has no duty to inquire about his stockbroker, even if confronted with suspicious circumstances.<sup>44</sup> In any event, Madoff’s investors may have had some cause for assurance. In particular, many of them knew that the SEC had investigated Madoff and had never uncovered any financial wrongdoing.<sup>45</sup> They may even have reasonably relied on the fact that financial regulators believed Madoff’s business to be clean.<sup>46</sup> Indeed, if the SEC proved

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<sup>41</sup> See, e.g., Robert Chew, *A Madoff Whistle-Blower Tells His Story*, TIME, Feb. 4, 2009, available at <http://www.time.com/time/business/article/0,8599,1877181,00.html> (“Madoff’s greatest talent, the witness indicated, was his use of a ‘hook’ or lure to play ‘hard to get’ and the false security of exclusivity, a hallmark of a Ponzi scheme.”); DAVID E.Y. SARNA, HISTORY OF GREED: FINANCIAL FRAUD FROM TULIP MANIA TO BERNIE MADOFF, ch. 21 (2010).

<sup>42</sup> See, e.g., Sullivan, *supra* note 9, at 1622-23.

<sup>43</sup> See *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 31 (2009) (testimony of Harry Markopolos, Chartered Financial Analyst, Certified Fraud Examiner) [hereinafter *Hearings*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-111hhr48673/pdf/CHRG-111hhr48673.pdf> (last visited Nov. 5, 2012). See generally Richard Posner, *Bernard Madoff and Ponzi Schemes—Posner’s Comment*, BECKER-POSNER BLOG (Dec. 21, 2008, 3:45 PM), <http://www.becker-posner-blog.com/2008/12/bernard-madoff-and-ponzi-schemes-posners-comment.html> (“The strategy . . . attributed to Madoff is the opposite of that of the typical Ponzi schemer: it [wa]s to obtain investments from well-off people far more financially sophisticated than the average Ponzi victim, including genuine financial experts such as hedge fund managers and bank officials. And therefore it require[d] different tactics from that of the ordinary Ponzi scheme, such as offering returns only moderately above average, satisfying redemption requests promptly, turning down some would-be investors . . . , and trading on a reputation earned in a legitimate business (Madoff’s business of market making).”).

<sup>44</sup> See, e.g., *Picard v. Katz*, 462 B.R. 447, 455 (S.D.N.Y. 2011) (citing *In re New Times Sec. Servs.*, 371 F.3d 68, 87 (2d Cir. 2004)). On the other hand, an investor will undercut his claim to have proceeded in good faith if he has willfully blinded himself to red flags. See *id.* at 455.

<sup>45</sup> See, e.g., Zachary A. Goldfarb, *SEC Lawyer Raised Madoff Concerns but was Rebuffed*, L.A. TIMES, July 2, 2009, at B3, available at <http://articles.latimes.com/2009/jul/02/business/fi-sec-madoff2>.

<sup>46</sup> See, e.g., Herve Stolowy et al., *Information, Trust and the Limits of “Intelligent Accountability” in Investment Decision Making: Insights from the Madoff Case 15-17* (Sept. 17, 2011) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1930128](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1930128) (collecting quotes from Madoff investors who stated

incapable of detecting the fraud, it is not reasonable to suppose that the average investor should have done so. Thus, we may assume that many investors in Madoff's scheme were blamelessly ignorant of his wrongdoing.<sup>47</sup> Many investors profited from the fraud, but they did so innocently; they did not know, and had no reason to know, that Madoff was operating a Ponzi scheme.<sup>48</sup>

With markets crashing in the fall of 2008, an unexpected number of Madoff customers sought to liquidate their accounts. Because Madoff could not possibly satisfy all of the claims, the scheme went bust.<sup>49</sup> After Madoff confessed to his family on December 10, 2008, his sons consulted with their lawyer and tipped the police off to the fraud. Madoff was arrested the next day.<sup>50</sup> At the time, Madoff had 4800 customers with open accounts, who had invested a total of \$20 billion in principal and accumulated an aggregate (fictitious) sum of \$65 billion, according to their last statements on November 30, 2008.<sup>51</sup> It was clear that Madoff did not have \$20 billion in assets to return to his customers, let alone the \$65 billion they thought they were owed.<sup>52</sup> The company officially went into bankruptcy on the day of Madoff's arrest.<sup>53</sup>

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that they were reassured that the investment scheme was legitimate as a result of the SEC's failure to uncover any fraud).

<sup>47</sup> See generally Felicia Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor,"* 40 U. BALT. L. REV. 215, 273 & n.305 (2010) (citing arguments that regulations concerning who counts as a sophisticated investor are too broad as, for example, where a high net wealth is sufficient to qualify the investor as "sophisticated").

<sup>48</sup> Picard acknowledges this when he states, on the webpage summarizing his efforts, that "[s]ome BLMIS customers *unwittingly* withdrew funds that were, in reality, money stolen by Madoff from other BLMIS customers." *A Message from SIPA Trustee Irving H. Picard*, MADOFF RECOVERY INITIATIVE, <http://madoff.com/trustee-message-24.html> (last visited Mar. 6, 2012) (emphasis added).

<sup>49</sup> See, e.g., David A. Gradwohl & Karin Corbett, *Equity Receiverships for Ponzi Schemes*, 34 SETON HALL LEGIS. J. 181, 189 (2010) ("With Madoff, the engine of fraud churned on until the collapse of the securities markets caused new investors to stop feeding the scheme and made it impossible for Madoff to continue.").

<sup>50</sup> See, e.g., *The Madoff Case: A Timeline*, WALL ST. J. (Mar. 12, 2009), [http://online.wsj.com/article/SB112966954231272304.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB112966954231272304.html?mod=googlenews_wsj); Diana B. Henriques, *New Description of Timing on Madoff's Confession*, N.Y. TIMES, Jan. 9, 2009, at B1, available at [http://www.nytimes.com/2009/01/10/business/10madoff.html?\\_r=1](http://www.nytimes.com/2009/01/10/business/10madoff.html?_r=1); Ellen S. Podgor, *Madoff*, WHITE COLLAR CRIME PROF BLOG (Dec. 16, 2008), [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/2008/12/the-madoff-case.html](http://lawprofessors.typepad.com/whitecollarcrime_blog/2008/12/the-madoff-case.html) (listing a variety of media reports on the Madoff ponzi scheme).

<sup>51</sup> See, e.g., Allison Hoffman, *Prosecutors Submit Scam E-mail with Madoff Victim Letters*, JERUSALEM POST, Mar. 24, 2009, available at <http://www.jpost.com/International/Article.aspx?id=136942>.

<sup>52</sup> See, e.g., Linda Sandler, *Madoff Brokerage, Homes, Boats Valued at \$1 Billion (Update2)*, BLOOMBERG (Jan. 9, 2009, 11:43 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZP0jyjuTdTI>.

<sup>53</sup> See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff)*, 429 B.R. 423 (Bankr. S.D.N.Y. 2010), *aff'd*, 848 F. Supp. 2d 469

Pursuant to the Securities Investor Protection Act (SIPA), Irving Picard was appointed as a trustee to recover money and redistribute it to creditors of the estate.<sup>54</sup> SIPA instructs the trustee “to distribute customer property and . . . otherwise satisfy net equity claims,”<sup>55</sup> and “to liquidate the business of the debtor.”<sup>56</sup> For the latter, the trustee must proceed in accordance with the bankruptcy code under Title 11.<sup>57</sup>

In structuring his recovery efforts, the trustee has been required to address two broad questions: first, who is entitled to restitution, and second, who should provide restitution to those entitled to it? The clawback suits against innocent investors provide a partial response to the second question, and their justifiability is the major focus of this Article. Nonetheless, an examination of the trustee’s response to the first question is also useful, since it demonstrates the legal uncertainty in this area and sets the stage for the clawback suits.

### B. *Defining “Net Equity”*

The Securities Investor Protection Act (SIPA) provides that, in the event that a broker-dealer fails and is unable to cover its obligations, the trustee shall “distribute customer property and otherwise satisfy net equity claims of customers.”<sup>58</sup> Among the first questions for Picard to resolve were who would count as a customer entitled to “customer property,” and what net equity were these customers due. In Madoff’s case, delineating the set of customers was rather complicated. While some of those who lost money as a result of Madoff’s fraud and wanted to press claims of relief had invested directly with Madoff, others had invested in Madoff “feeder funds.” Sixteen

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(S.D.N.Y. 2012); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (*In re Bernard L. Madoff Inv. Sec. LLC*), 424 B.R. 122, 124 & n.3 (Bankr. S.D.N.Y. 2010), *aff’d*, 654 F.3d 229 (2d Cir. 2011).

<sup>54</sup> See, e.g., *A Message from SIPA Trustee, Irving H. Picard*, MADOFF RECOVERY INITIATIVE, <http://www.madoff.com/trustee-message-02.html> (last visited Mar. 6, 2012). This is the trustee home page for the website the Madoff SIPA trustee has established to report on the progress of the case and provide interested parties with relevant information. On this page, Picard explains that “On the day the news [of Madoff’s fraud] broke, I received a call from the Securities Investor Protection Corporation (‘SIPC’) and was asked to serve as SIPA Trustee for the liquidation of Bernard L. Madoff Investment Securities LLC (‘BLMIS’) under the Securities Investor Protection Act (‘SIPA’).”

<sup>55</sup> Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff(a)(1)(B) (2006).

<sup>56</sup> *Id.* § 78fff(a)(4).

<sup>57</sup> *Id.* § 78fff-4(e).

<sup>58</sup> *Id.* § 78fff(a)(1)(B).

feeder funds brought suit, seeking to have their status as SIPA investors recognized. Judge Burton Lifland, the bankruptcy judge handling the Madoff SIPA liquidation, denied them relief and held that they do not count as “customers” under the SIPA statute.<sup>59</sup> The feeder funds appealed, but Judge Lifland’s decision was affirmed by the District Court for the Southern District of New York in an opinion issued in January of this year.<sup>60</sup>

When it came to determining the customers’ “net equity”—i.e., the money they were entitled to recover—there arose a “controversy of staggering proportions involving statutory interpretation, statutory purpose, the relationship of multiple SIPA and bankruptcy law provisions, and fundamental bankruptcy law philosophy.”<sup>61</sup> Using the “Last Statement” method of calculating net equity, investors in Madoff’s scheme asserted claims in the amounts listed on the last statements they had received before the fund’s collapse.<sup>62</sup> On the other hand, relying on the “Net Investment” or “Cash-In-Cash-Out” method, Picard, along with the SEC and SIPC, believed that the Madoff investors should be entitled only to the amounts they had deposited, minus any money withdrawn.<sup>63</sup>

In a March 1, 2010 opinion, Judge Lifland adopted the “Net Investment” method: customers would be entitled to

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<sup>59</sup> See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec.*, 454 B.R. 285 (Bankr. S.D.N.Y. 2011), *aff’d sub nom. Aozora Bank Ltd. v. Sec. Investor Prot. Corp.*, No. 1:11-CV-05683-DLC, 2012 BL 54585 (S.D.N.Y. Jan. 4, 2012).

<sup>60</sup> See generally *Aozora Bank*, 2012 BL 54585.

<sup>61</sup> Paul Sinclair & Brendan McPherson, *The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part IV*, 29 AM. BANKR. INST. J., May 2010, at 18.

<sup>62</sup> See, e.g., *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 233 (2d Cir. 2011); Peter J. Henning, *The Next Test for the Madoff Trustee*, N.Y. TIMES (DEALBOOK) (Mar. 2, 2011, 8:50 AM), <http://dealbook.nytimes.com/2011/03/02/the-next-test-for-the-madoff-trustee/>.

<sup>63</sup> See *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 233; Henning, *supra* note 62. It may be worth noting in this context that SIPC pays Picard’s salary for the Madoff litigation (though SIPC will recover the payments it makes to Picard through whatever funds he is able to recoup). See, e.g., Gretchen Morgenson, *Many Holes Weaken Safety Net for Victims of Failed Brokerages*, N.Y. TIMES, Sept. 25, 2000, at A1, A24. This arrangement can prompt the trustee in a SIPA proceeding, who likely wants to become or remain a repeat player in this game, to be chary with claims and aggressive with recovery efforts. *Id.* An uncharitable take on Picard would find evidence for this motivation in his narrow reading of “net equity.” Cf. Paul Sinclair & Brendan McPherson, *Does SIPC Protect Customers in Ponzi Scheme Cases? Sad Tales of Multiple Overlapping Fraudulent Transfers IV*, 7 AM. BANKR. INST.: COMMERCIAL FRAUD COMM. NEWS, Sept. 2010, at 267-68, available at <http://www.abiworld.org/committees/newsletters/CFTF/vol7num3/sipc.pdf> (commenting on the “net equity” decision in the Madoff case, and contending that “[t]his SIPC controversy . . . is further infected by the SIPC’s position as an industry body, rather than a governmental agency charged to protect investors, and thus its alleged effort to simply reduce its losses to the most limited amounts”).



recover only their principal, minus any withdrawals they had made over the life of their investments.<sup>64</sup> The Second Circuit affirmed this decision in an opinion issued on August 16, 2011,<sup>65</sup> adducing three grounds in support of its decision. Specifically, the court argued that allowing the net winners to recover any of the money they believed resided in their accounts would (1) place the trustee in the impossible position of having to invent recovery entitlements, given that Madoff's records were completely fictitious and could not provide any basis for ascertaining how much "profit" any investor was due; (2) unjustly enrich the winners at the expense of the losers; and (3) problematically legitimate Madoff's fraud by recognizing and upholding the fiction he had perpetrated. I address each of these in turn, and argue that none is convincing on its own or in combination with the others.

### 1. Unascertainable Holdings

The court's first set of arguments relates to administrative convenience. The SIPA statute requires the trustee "to make payments to customers based on 'net equity' insofar as the amount owed to the customer is 'ascertainable from the *books and records* of the debtor or [is] otherwise established to the *satisfaction of the trustee*.'"<sup>66</sup> Because Madoff's books and records were "after-the-fact constructs that were based on stock movements that had already taken place," the Second Circuit found that net equity could not be ascertained by reference to them.<sup>67</sup> However, it is worth noting that the plain text of the SIPA statute does not restrict net equity calculations to those ascertainable from the debtors' books and records, but instead explicitly allows alternative methods that are "to the satisfaction of the trustee."<sup>68</sup> Elsewhere, the court acknowledged the considerable discretion

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<sup>64</sup> See *In re Bernard L. Madoff Inv. Sec.*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011).

<sup>65</sup> See generally *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d 229. A group of investors who would be ineligible for net equity under the decision filed an appeal with the Supreme Court, which denied certiorari on June 25, 2012. See *Velvel v. Picard*, No. 11-986, 2012 WL 435188, at \*1 (U.S. June 25, 2012); *Ryan v. Picard*, No. 11-969, 2012 WL 396489, at \*1 (U.S. June 25, 2012).

<sup>66</sup> *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 237 (quoting 15 U.S.C. § 78fff-2(b) (2006)) (alteration in original).

<sup>67</sup> *Id.* at 238.

<sup>68</sup> 15 U.S.C. § 78fff-2(b)(2).

a SIPA trustee possesses in determining net equity,<sup>69</sup> thereby refusing to endorse the Cash-In-Cash-Out method as the strategy to be pursued in each and every case.<sup>70</sup> Thus, it is possible that an alternative to both the Last Statement and Net Investment methods exists, that this alternative is preferable as a matter of fairness to either of these methods, and that the trustee would be acting within his authority were he to pursue it.<sup>71</sup> As the court itself acknowledged, it would be compelled to “accord a degree of deference to [the trustee’s] exercise of discretion so long as the method chosen by the trustee allocates ‘net equity’ among the competing claimants in a manner that is not clearly inferior to other methods under consideration.”<sup>72</sup>

With that said, since the pool of accumulated funds would be divided among a greater number of claimants, an alternative definition of net equity that enlarges the set of investors entitled to recovery would entail, all else being equal, a smaller recovery for each. This would mean that investors who had not recovered their principal at the time of the scheme’s collapse would be made less whole under this alternative than under the Cash-In-Cash-Out method—a problematic outcome if one believes that all of the investors should be restored to their pre-Madoff positions before any of them is entitled to profit from

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<sup>69</sup> “[I]n many circumstances a SIPA trustee may, and should, exercise some discretion in determining what method, or combination of methods, will best measure ‘net equity.’” *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 238 n.7. Cf. Sullivan, *supra* note 9, at 1600 (noting, in the context of a bankruptcy trustee’s efforts to recover money for defrauded investors in a Ponzi scheme that “the court is given broad powers to rule on a plan of distribution, subject only to the requirement that the court use its discretion in a logical way to divide the money.”) (citations omitted); Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the “Clawback” Remedy in the Current Financial Crisis*, 72 TEX. B. J. 922, 926 (2009) (“The trustee or receiver in a Ponzi scheme has a fair amount of discretion in whether to pursue claims against investors and other transferees.”).

<sup>70</sup> Thus the court made clear that its approach here was determined by the unique circumstances of the case:

In holding that it was proper for Mr. Picard to reject the Last Statement Method, we expressly do not hold that such a method of calculating “net equity” is inherently impermissible. To the contrary, a customer’s last account statement will likely be the most appropriate means of calculating “net equity” in more conventional cases . . . . The extraordinary facts of this case make the Net Investment Method appropriate, whereas in many instances, it would not be.

*In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 238.

<sup>71</sup> For example, the trustee might have determined what each Madoff investor would have been owed had Madoff invested all of the money he received in an S&P 500 index for the duration of the investment; the trustee could then have taken this sum as the basis for determining each investor’s pro rata share, with deductions for money already withdrawn.

<sup>72</sup> *Id.* at 238 n.7.

the scheme. Indeed, this concern appears to animate the court's second and third lines of argument.

## 2. Unjust Enrichment

In a second set of arguments, the court expressed concern that crediting investors with any amount of "interest" would leave less money in the pot with which to make losing investors whole.<sup>73</sup> As an initial matter, it is certainly true that permitting principal plus some *post hoc* assignment of profits as the basis of recovery—rather than principal alone—would create a larger outstanding sum owed to investors, such that each losing investor would receive less than under the Net Investment method. But this outcome represents an "inequitable consequence" only if we have reason to privilege lost principal over lost (purported) earnings.

Under a legitimate investment, winning customers who had not yet cashed out would be owed the amounts on their last statements, even though they had already recovered the amounts of their deposits and even if, because of the estate's insolvency, seeking to pay the winners their outstanding profits would entail that losing customers would receive less than the full amount of *their* deposits in return. In other words, where there has been legitimate investment activity, bankruptcy law does not require that each investor receive his out-of-pocket investment amount before any investor can receive earnings on top of that investment. Yet, in such a case, winning investors do receive an "additional benefit at the expense of" losing investors.<sup>74</sup> The question then arises: If the disparity isn't unfair in the case of genuine investments, why does the fictitious nature of the investments render it unfair? The court, in its third argument, offers what appears to be a response.

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<sup>73</sup> "The inequitable consequence of such a scheme would be that those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed." *Id.* at 238; *see also id.* at 235 (quoting approvingly from the bankruptcy court's underlying opinion, in which Judge Lifland argued that "[a]ny dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested." *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec.*, 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010)).

<sup>74</sup> *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 238.

### 3. Legitimizing Fraud

In endorsing the trustee's interpretation of net equity, the court stated that the "[t]rustee properly declined to calculate 'net equity' by reference to impossible transactions. Indeed, if the [t]rustee had done otherwise, the whim of the defrauder would have controlled the process that is supposed to unwind the fraud."<sup>75</sup> Part of the court's concern arose from the fact that the "profits" Madoff recorded "were arbitrarily and unequally distributed among customers."<sup>76</sup> For instance, Madoff accorded significantly higher returns to his preferred clientele; the disparity in return rates had nothing to do with market performance and everything to do with Madoff's whims.

The court correctly agreed with the trustee in declining to countenance this aspect of the fraud. As the bankruptcy judge had stated—and the Second Circuit quoted approvingly—the trustee rightly "refuse[d] to permit Madoff to arbitrarily decide who wins and who loses."<sup>77</sup> This refusal correctly impugns the Last Statement method, at least as it applies to those whose account statements were whimsically inflated by Madoff. But again, it does not compel the Net Investment method. The trustee might instead have found an objective measure to project the amount investors would have been owed had Madoff invested their money in a legitimate vehicle. In this way, he would not have had to rely on, let alone credit, the disparate ways in which Madoff treated his investors.

Further, contrary to the suggestion of the bankruptcy court and Second Circuit, there is no basis for the notion that recognizing a recovery amount that allows interest on investors' deposits involves a kind of complicity in, or affirmation of, the fraud.<sup>78</sup> Indeed, one might wonder how seeking to make all investors whole, or fulfilling their "legitimate expectations," *legitimizes* Madoff's fraud, rather than undercuts it. After all, in a Ponzi scheme, it is presumed that the scheme's operator *intends* to defraud or otherwise

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<sup>75</sup> *Id.* at 241.

<sup>76</sup> *Id.* at 238.

<sup>77</sup> *Id.* (quoting *In re Bernard L. Madoff*, 424 B.R. at 140) (internal quotation marks omitted).

<sup>78</sup> See *In re Bernard L. Madoff Inv. Sec.*, 654 F.3d at 238; *In re Bernard L. Madoff*, 424 B.R. at 136 (stating that the Net Investment method allowed Picard to "unwind[], rather than legitimiz[e], the fraudulent scheme").

hinder his investors' ability to recover their investment.<sup>79</sup> A recovery program more expansive than Picard's would then thwart, rather than serve, this presumed intention.

In sum, the Last Statement method may well be flawed. But it is not at all clear that the Net Investment method is more justifiable, either as a matter of law or fairness. Indeed, the Net Investment method generates fairness concerns that extend well beyond the denial of the winners' claims to any recovery.<sup>80</sup>

### C. *Setting the Stage for the Clawback Actions*

To grasp the implications of the net equity decision for the clawback actions, it will be helpful to consider a hypothetical Madoff investor. Suppose, for example, that investor Smith opened an account with Madoff in 1980 with a one-time deposit of \$1 million, and that he withdrew money from his account only once, in 2004, when he retrieved \$2 million; then, on November 30, 2008, Smith received a statement from BLMIS indicating that he had \$8 million left in his Madoff account. How would Smith fare in light of the net equity decision?

First, that decision allowed Madoff's customers to be divided into two groups—"winners" and "losers." "Winners" were those investors who had withdrawn more money from their accounts than they had deposited. "Losers," on the other hand, still had some or all of their principal invested with Madoff at the time of the fund's collapse, and they would sustain a net loss if that money were not returned to them. Because the amount of Smith's 2004 withdrawal (\$2 million) was greater than the amount of his total deposit (\$1 million), he would be counted among the Madoff "winners."

Second, the decision entailed that only the Madoff "losers" would count as "customers" for purposes of recovering net equity. Net "winners," on the other hand, would join the ranks of other creditors of the estate, recovering the fictitious amounts they thought they were owed only if the "losers" were first made whole.<sup>81</sup> Thus, even though Smith reasonably relied upon the veracity of his BLMIS statements, including the last statement

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<sup>79</sup> See *infra* note 90 and accompanying text (describing the Ponzi scheme presumption).

<sup>80</sup> See *infra* note [redacted] (discussing the fairness implications of the Net Investment method).

<sup>81</sup> See, e.g., *What Is the Difference Between the Customer Fund and the General Estate?*, MADOFF RECOVERY INITIATIVE, <http://www.madoff.com/facts-08.html> (last visited Aug. 15, 2012).

indicating an \$8 million balance in his Madoff account, he would not be entitled to recover any more than \$1 million under the Bankruptcy Court's interpretation of net equity.

Third, the problem is not simply that "winners" with open accounts would be barred from recovering any money as customers of the estate. They might also be required to return their "winnings"—i.e., all money withdrawn in excess of that which they had invested. Thus, Smith could be subject to a clawback action for the \$1 million withdrawn in excess of his \$1 million investment. Indeed, we now know that many real-life "winners" in Madoff's Ponzi scheme, including some whom Picard believes to have been innocently ignorant of the fraud, have been named as defendants in his clawback suits.

Finally, if the bankruptcy trustee could establish that Smith evinced a lack of good faith at the time that he received the \$2 million, matters would be even worse for Smith in light of the bankruptcy code provision described below, which allows the trustee to void a transfer if the transferee knew or had reason to know of the fraud at the time of the transfer. In that case, the trustee could seek return of not just the \$1 million in "profits" that Smith withdrew, but also the \$1 million that represented Smith's principal. In other words, if it were shown that Smith knew or had reason to know of the fraud, the entire \$2 million transfer could be voided, leaving Smith with a net loss of one million real dollars.<sup>82</sup> Here, too, there are real-world examples, including the clawback suit Picard filed against the owners of the New York Mets, whom he has accused of willful ignorance, and against whom he sought return of both principal and "profits."<sup>83</sup>

Critically, the net equity decision did not, as a matter of law or logic, compel the Trustee's clawback suits. One could consistently hold *both* that Madoff investors with outstanding account balances were not eligible to recover more money than they had deposited *and* that those investors who had already

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<sup>82</sup> In *Picard v. HSBC Bank PLC.*, Judge Jed Rakoff dismissed the bankruptcy trustee's common law aiding and abetting claims against HSBC, which is accused of having funneled investors to Madoff, in part on the basis of the doctrine of *in pari delicto*, or "unclean hands." 454 B.R. 25, 37 (Bankr. S.D.N.Y. 2011). That doctrine prevents one wrongdoer from suing one of her fellow wrongdoers for damages arising from their shared wrongdoing. *Id.* With the *HSBC* decision as support, it may be that investors accused of bad faith will raise an *in pari delicto* defense. See Peter J. Henning, *Madoff Trustee's Job Just Became Much Tougher*, N.Y. TIMES (DEALBOOK) (July 29, 2011), <http://dealbook.nytimes.com/2011/07/29/madoff-trustees-job-just-became-much-tougher/>.

<sup>83</sup> See, e.g., Toobin, *supra* note 8.

withdrawn more than they had deposited would nonetheless get to keep the withdrawn “profits.” Put another way, the fact that “winners” would not be entitled to recovery in the bankruptcy proceedings need not have entailed that they would have an additional obligation to return the “winnings” they received before the bankruptcy. Thus, to return to our hypothetical example, Smith could have been foreclosed from seeking to recover the \$8 million he thought he had in his Madoff account but permitted to keep the \$2 million he had withdrawn.<sup>84</sup>

Nonetheless, as of December 10, 2010, Picard had filed complaints against over one thousand investors seeking return of their “fictitious profits,” and in some cases their withdrawn principle,<sup>85</sup> for a total possible recovery of more than \$100 billion.<sup>86</sup> I turn now to an analysis of the doctrinal foundations for these suits.

## II. THE DOCTRINE OF FRAUDULENT CONVEYANCE

The term “Ponzi scheme” dates back to the infamous scheme perpetrated by Charles Ponzi in the early 1920s.<sup>87</sup> Yet it was only in the mid-1980s that bankruptcy trustees in Ponzi scheme cases began to pursue clawback actions against

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<sup>84</sup> One might worry that, given that the estate was bankrupt, there would have been no money with which to make the losers whole unless Picard pursued clawbacks against innocent winners. But as I describe *infra*, Picard ended up filing clawback suits seeking a total of more than \$100 billion, even though the outstanding principle did not amount to more than \$20 billion. See *infra* note 85 and accompanying text. The \$100 billion figure stemmed from claims of punitive damages in those cases where the trustee alleged that the transferee had known of, or been willfully blind to, the fraud, and so would not be permitted to keep either the principal or profits. See, e.g., Complaint at ¶ 8, *Picard v. JPMorgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2010) (seeking \$19 billion, comprised of money the bank earned from Madoff’s account as well as punitive damages). In short, there might well have been enough money to fund the recovery even if the innocent winners were not made to contribute to the customer fund. And, even if there wouldn’t have been enough money, it is not at all clear that that outcome would be unfair to the losers—indeed, that is just the issue I seek to settle here.

<sup>85</sup> See, e.g., Joe Palazzolo, *Picard Dealt Another Blow*, WALL ST. J. LAW BLOG (Nov. 2, 2011, 11:34 AM), <http://blogs.wsj.com/law/2011/11/02/picard-dealt-another-blow-by-sdny/>.

<sup>86</sup> See, e.g., *id.*

<sup>87</sup> See *Cunningham v. Brown*, 265 U.S. 1, 7-9 (1924) (discussing the collapse of Charles Ponzi’s fraudulent investment program); Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (1998). Ponzi was not the first to perpetrate the kind of fraud that now bears his name. In 1880, for example, Ferdinand Ward orchestrated just this kind of fraud, ensnaring, among others, Ulysses S. Grant. See generally GEOFFREY C. WARD, A DISPOSITION TO BE RICH (2012) (a recounting of Ferdinand Ward’s fraud written by a renowned historical writer, who happens to be the fraudster’s great-grandson).

innocent investors who withdrew more than they had invested in the scheme.<sup>88</sup> The clawback suits rely upon a provision of the bankruptcy code that SIPA borrows from,<sup>89</sup> allowing a SIPA trustee to void (or, to use the technical term, “avoid”) any transfer from the debtor’s estate that was conveyed fraudulently.<sup>90</sup> More specifically, 11 U.S.C. § 548 provides that a bankruptcy trustee:

may avoid any transfer . . . if the debtor voluntarily or involuntarily (A) made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made . . . , indebted; or (B)(i) received less than a reasonably equivalent value in exchange for such transfer . . . ; and (ii) [the debtor was insolvent, undercapitalized, or overextended at the time of the transfer, or he became so as a result of the transfer].<sup>91</sup>

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<sup>88</sup> A Westlaw search for all federal and state cases containing the terms “Ponzi” and “fraudulent conveyance” or “fraudulent transfer” turns up 190 cases. Only four of these arose before 1984. The first three stem from Charles Ponzi’s scheme itself, and only one of these was successful. More specifically, in *Engstrom v. Lowell*, the trustee lost because the law in question required the trustee to establish that the defendant—*i.e.*, the target of the clawback suit—had actual knowledge of the fraud, and this the trustee failed to do. 281 F. 973, 976 (1st Cir. 1922). The trustee lost a second case arising from Ponzi’s fraud on similar grounds. *See Cunningham v. Merchs.’ Nat’l Bank of Manchester, N.H.*, 4 F.2d 25 (1st Cir. 1925). In a 1924 opinion, the Supreme Court did approve the trustee’s efforts to void the withdrawals investors in Ponzi’s fraud made after the *Boston Post* exposed the fraud, *Cunningham*, 265 U.S. at 9-14, but the clawbacks in that case derived not from the Bankruptcy Code’s fraudulent transfer provision—as Picard’s clawback suits do—but instead from its preference avoidance provision. I elaborate on the distinction between these two provisions below. *See infra* notes 107-109 and accompanying text. The next published opinion involving clawbacks from investors in a Ponzi scheme was issued in a 1966 case where the Sixth Circuit affirmed the District Court’s decision allowing the bankruptcy trustee to reclaim money received by an associate of the Ponzi schemer who was held to have had reason to know, if not actual knowledge of the fraud. *See Conroy v. Shott*, 363 F.2d 90, 92-93 (6th Cir. 1966). That case, thus, did not involve an innocent investor. The first published case involving a successful avoidance action against an innocent investor on fraudulent conveyance grounds was decided in 1989. *See Wootton v. Barge*, 875 F.2d 508, 510-11 (5th Cir. 1989). Federal bankruptcy law was overhauled in 1979, with the Bankruptcy Reform Act of 1979 replacing the Bankruptcy Act of 1898. *See, e.g.*, Robert J. White, *Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code—Like Oil and Water, They Just Don’t Mix*, 1991 ANN. SURV. AM. L. 357, 358 (1991). Nonetheless, fraudulent conveyances provisions can be found in both Acts, *see id.*, and Ponzi scheme cases date back to the 1920s, so the upswing in Ponzi scheme clawback cases cannot be attributed to the statutory change.

<sup>89</sup> *See* 11 U.S.C. § 548(a)(1)(A)-(B) (2006).

<sup>90</sup> Excellent overviews of the doctrine governing clawbacks in the wake of a Ponzi scheme can be found in Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 223-25 (1998); *see also* Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 223 n.7 (2009).

<sup>91</sup> 11 U.S.C. § 548(a)(1)(A)-(B) (2006).



Subsection (A) of the provision pertains to cases of actual fraud,<sup>92</sup> while subsection (B) pertains to cases of constructive fraud.<sup>93</sup>

On its face, the text of this provision permits two different interpretations of the provision's rationale. According to the first, the purpose of the fraudulent transfer provision is

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<sup>92</sup> Courts proceed as if there is a presumption of actual fraud in every Ponzi scheme case, since there will never be enough money in the scheme to provide all investors with a return of their principal along with the promised returns, and "since a failure to redeem in accordance with the investor's expectation based on inflated account statements would . . . result[] in the investigation and discovery of the fraud." Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis*, 72 TEX. B.J. 922, 926 (2009) (citing *In re Bayou Grp.*, 396 B.R. 810, 843 (S.D.N.Y. 2008)). See, e.g., *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 8 (S.D.N.Y. 2007) ("There is a general rule—known as the 'Ponzi scheme presumption'—that such a scheme demonstrates 'actual intent' as matter of law because 'transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors.'" (citation omitted)); *Sec. & Exch. Comm'n v. Res. Dev. Int'l*, 487 F.3d 295, 301 (5th Cir. 2007) ("In this circuit, proving that IERC (International Education Research Corporation) operated as a Ponzi scheme establishes the fraudulent intent behind the transfers it made." (citation omitted)). See generally McDermott, *supra* note 87, at 173-74 & n.66 (collecting cases). Nonetheless, a lawyer representing a defendant in a clawback suit might want to argue that the presumption is unwarranted. The actual fraud provision refers not to the Ponzi scheme operator's global or over-arching intention with respect to the scheme, but rather to the operator's intentions relative to the transfers that are the subject of the clawback suit. It may be that the operator had no intention to defraud anyone when he made *those* transfers. Indeed, this would seem to be especially true for those transfers made early in the scheme, when the operator might well have believed that the scheme was a temporary measure, and that subsequent legitimate investments would allow him to recover the money that he had diverted from one investor to another, thereby restoring the investor whose investment had been diverted.

<sup>93</sup> It is worth noting that there is a disagreement among courts as to whether the investor's deposits constitute "reasonably equivalent value" for any profits she receives over and above the amount deposited. See, e.g., McDermott, *supra* note 90, at 164-65 & n.36 (collecting cases). Judge Posner has argued that the fictitious profits should be subject to clawback even if one grants that the investor's principal constituted fair consideration:

We said that [the clawback target's] profit was supported by consideration. But what was the source of the profit? A theft by [the ponzi scheme operator] from other investors. What then is [the clawback target's] moral claim to keep his profit? None, even if the intent in paying him his profit was not fraudulent.

*Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995). Posner's argument begs the question insofar as it privileges the "theft" that the scheme perpetrates against the losing investor over the fraud that the scheme perpetrates against the winning investor: Suppose that the debtor genuinely owed *W* money, and that the debtor could obtain the money owed only by stealing from *L*, and so the debtor proceeded to steal from *L*. We would think that *W* was required to return the money to *L* only if we discounted *W*'s claim to the money. But why should the debtor's obligation to give money to *W* count for less than *L*'s entitlement to the stolen money? To be sure, the situation looks like the classic case of stolen goods, where the bona fide recipient must return the stolen good even if she had no reason to know it was stolen when she acquired it; Posner's rhetoric—referring to the Ponzi scheme as a theft—certainly underscores the force of the analogy. Nonetheless, I go on to discuss both the ways in which the law of stolen goods is both inapposite and inadequately justified. See *infra* Part III.B.

to prevent the debtor from secreting away his assets, typically for his own benefit, such that they are beyond the reach of his creditors. I refer to this as the *anti-fraud reading* (AF) of § 548. According to the second, the *even distribution reading* (ED), the purpose of the fraudulent transfer provision is to ensure the most even distribution of assets as possible by conferring upon each creditor his pro-rata share of the recovered resources.<sup>94</sup> Put differently, AF attends to the value of the estate, while ED attends to its distribution among creditors. In this Part, I argue that Picard's clawback actions find support only in the ED reading of § 548, but that the history and text of § 548 strongly favor the AF reading.

A. *The Even Distribution (ED) Reading*

One could argue that the letter of the law is compatible with the ED reading and therefore supports the clawback actions. For example, subsection (B) under § 548, which is intended to cover instances of constructive fraud, allows for avoidance of a transfer “if the debtor voluntarily or involuntarily . . . (i) received less than a reasonably equivalent value in exchange for such transfer,” and (ii) the debtor was insolvent, undercapitalized, or overextended at the time of the transfer, or he became so as a result of the transfer.<sup>95</sup> In defending the propriety of the Madoff clawback suits against this provision, one could contend that any “profits” that a Madoff customer withdrew were profits for which the fund received less than a “reasonably equivalent value.” This money exceeds the amount the customer had invested. Further, since Madoff had promised customers returns that he could not possibly produce—again, he hadn't invested their deposits at all, so there was no way for the deposits to appreciate in value—he was necessarily insolvent at the time of any customer's withdrawal. Thus, the winners' “winnings” appear to satisfy § 548's criteria for a constructively fraudulent transfer and accordingly appear subject to avoidance.

The problem with this reasoning is that the clawback actions deviate from the spirit of the fraudulent transfer

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<sup>94</sup> Robert Clark uses the term “evenhandedness” to refer to one of the objectives of the avoidance provisions in bankruptcy law. Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 511-12 (1977). As he explains, “the ideal of Evenhandedness toward creditors . . . connot[es] . . . equality of treatment of legal obligations in connection with liquidation proceedings.” *Id.*

<sup>95</sup> 11 U.S.C. § 548(a)(1)(B).

provision. More specifically, if we look at the history of the fraudulent transfer provision, as well as other elements of the statutory scheme, it becomes clear that the intent of the fraudulent transfer provision is not to recoup money from transferees like the Madoff “winners.”

*B. The Anti-Fraud (AF) Reading*

The bankruptcy code’s fraudulent transfer provision has its genesis in the 1571 Statute of Elizabeth,<sup>96</sup> which is virtually identical in its language to the first part of the current fraudulent transfer provision. That 1571 law provided that creditors may avoid “fraudulent . . . Conveyaunces,” which were made with the “Intent to delaye[,] hynder[,] or defraude Creditors . . . .”<sup>97</sup> By comparison, 11 U.S.C. § 548(a)(1) provides: “The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily—(A) made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted . . . .”<sup>98</sup>

The basic idea behind the Statute of Elizabeth was to counteract certain kinds of mischief. For example, at the time, there were certain sanctuaries into which the king’s writ could not enter. As a result, debtors would take refuge in these sanctuaries, but before doing so, they would sell their assets to friends and family members for a nominal sum in order to prevent creditors from reaching them. Then, when their creditors finally gave up or the statute of limitations expired, the debtor would buy back the assets from his friends and family and, presumably, live happily ever after.<sup>99</sup> To prevent this practice, the Statute of Elizabeth was passed. For example, under the statute, if the debtor sold his flock of sheep for a pittance, creditors could avoid the transfer and undo it, thereby returning the sheep to the estate so that creditors could access their value.<sup>100</sup>

The untoward act that the Statute of Elizabeth contemplated was not one where the debtor gives money to

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<sup>96</sup> See Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 829-30 (1985).

<sup>97</sup> 13 Eliz. I, ch. 5 (1571) (Eng.), DURHAM UNIV. (UK), available at [http://familyrecords.dur.ac.uk/nei/NEI\\_13Elizabeth1c5.htm](http://familyrecords.dur.ac.uk/nei/NEI_13Elizabeth1c5.htm) (last visited Nov. 5, 2012).

<sup>98</sup> 11 U.S.C. § 548(a)(1)(A).

<sup>99</sup> See Baird & Jackson, *supra* note 96, at 829.

<sup>100</sup> The example is Baird and Jackson’s. See *id.* at 852.

creditor *A* and thereby leaves less in the pot for creditor *B*. It was instead the situation in which the debtor seeks to frustrate recovery on the part of *all* of his creditors, by transferring title of his assets to another with the express purpose of reclaiming them once the debtor was beyond the reach of his creditors. In other words, the Statute of Elizabeth did not seek an even distribution among all creditors. It merely sought to prevent situations where the debtor attempted to safeguard assets for his own enjoyment of them.

The rationale behind the Statute of Elizabeth is enshrined in current law, as can be gleaned from various elements in today's bankruptcy code. Consider, for example, the provision permitting avoidance of a transfer just so long as it was made with fraudulent intent.<sup>101</sup> If the objective of the fraudulent transfer provision were to ensure an even distribution among creditors, it would make no sense to permit avoidance only where the debtor transferred assets with an actual or constructive fraudulent intent. For example, suppose that the year before our "Elizabethan deadbeat"<sup>102</sup> became insolvent,<sup>103</sup> he gave his flock of sheep to his doctor in exchange for medical services rendered, with no expectation of having the sheep returned. The transfer would not be fraudulent, and yet the value of the estate would be diminished to the same extent as in the case where the debtor has given his brother the flock of sheep for the sake of putting them out of his creditors' reach. If we really were concerned about ensuring that all creditors share equally in the losses, we would require the doctor to return the sheep and line up with the other creditors for his pro rata share of the estate. Allowing the doctor to retain the sheep simply because they were not conveyed with a fraudulent intent suggests that we are not concerned with ensuring an even distribution.<sup>104</sup>

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<sup>101</sup> 11 U.S.C. § 548(a) (2006).

<sup>102</sup> Baird & Jackson, *supra* note 96, at 852.

<sup>103</sup> The hypothetical has the transfer occur a year before insolvency so that the transfer of the sheep cannot be avoided as a form of preference avoidance, the reach back period for which is less than one year.

<sup>104</sup> One might argue that the doctor is entitled to keep his sheep not because they were conveyed without fraudulent intent but because he qualifies for the "ordinary course of business" defense, as captured in contemporary law by 11 U.S.C. § 547. But this is just to beg the question, for why should paying for medical services count as part of the fraudster's "ordinary" business while returning money to investors does not? A purported distinction between the two seems to rest on the intuition that the doctor has provided a legitimate service to the fraudster; but the investors had no less reason than the doctor to believe that the transaction in which they engaged with

A second piece of evidence supporting the AF reading over the ED reading emerges from a provision in the bankruptcy code that allows the target of a clawback action to marshal a good faith defense. In particular, 11 U.S.C. § 548(c) provides that “a transferee . . . that takes *for value and in good faith* has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer . . . .”<sup>105</sup> Thus, for example, consider a Ponzi scheme with two customers—Smith and Jones. Smith and Jones both invest the same amount of money at the same time. Neither has any idea that they are investing in a Ponzi scheme, nor are there any red flags that should have put them on notice. Six months before the Ponzi scheme is exposed, Smith withdraws an amount equal to his principal. Because Smith will have taken “for value and in good faith,” he will get to keep 100 percent of the money he has withdrawn. If the Ponzi scheme operator is completely insolvent at the time the scheme collapses, Jones will end up with nothing. Again, in the case between Smith and Jones, if the purpose of § 548 were to ensure an even distribution between creditors, the fact that Smith had taken in good faith would be irrelevant. Smith would instead be required to give back 50 percent of the money he had withdrawn in order to offset Jones’s losses. The law, instead, provides that Smith gets to keep the full amount of his withdrawal, and Jones gets nothing.<sup>106</sup>

Moreover, the distinction between “*net winners*” and “*net losers*” lends further support to the AF reading. Where an investor has received no more than the amount she deposited, a

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the fraudster was legitimate. So, again, the question of the grounds for the disparity in treatment arises.

<sup>105</sup> 11 U.S.C. § 548(c) (emphasis added).

<sup>106</sup> In recent years, courts have narrowed the scope of the good faith defense, adopting a demanding objective standard. *See, e.g., In re Bayou Grp.*, 439 B.R. 284, 310-12 (S.D.N.Y. 2010) (describing the relevant test thusly: “The first question . . . is whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose . . . these two elements are consistently identified as the triggers for inquiry notice . . . . Once a transferee has been put on inquiry notice of either the transferor’s possible insolvency or of the possibly fraudulent purpose of the transfer, the transferee must satisfy a ‘diligent investigation’ requirement . . . . The test is most commonly phrased . . . as whether ‘diligent inquiry would have discovered the fraudulent purpose’ of the transfer.”).

Some commentators suggest that the narrow reading of the good faith defense is an intentional effort by courts to reach all payments, not just profits, so that early and late investors are at parity. This view is also shared by some judges, who view the narrow reading as judicial activism . . . .

Sullivan, *supra* note 9, at 1618 (citations omitted).

court could consider her withdrawals to represent (fictitious) interest payments, rather than return of principal, in which case the money withdrawn would not have been offset by the “reasonably equivalent value” that § 548(a)(1)(B) requires. This would be an especially plausible way to proceed where the Ponzi scheme operator specifically designated the withdrawals as payments of interest, rather than return of principal. Nevertheless, courts tend to credit payments first toward principal and then, only after the amount deposited has been fully withdrawn, toward interest. Thus one court stated that “[i]f a given defendant received less than his [investment], the amounts received should be considered return of principal, regardless of how the parties may have designated them.”<sup>107</sup> It is this treatment that allows us to consider the person who withdrew some money from her account—but less than she had invested—to be a net loser, rather than an investor who earned some profits from the Ponzi scheme. Yet again, if courts sought to achieve an even distribution among customers, it would make little sense to credit all payments up to the amount of the deposit as principal. This approach puts those payments beyond the bankruptcy trustee’s reach—because the investor has given reasonably equivalent value for these withdrawals under § 548(B)(i)—thereby leaving less money in the pot for redistribution. The fact that the doctrinal understanding of constructive fraud allows an innocent investor to keep the full amount of her principal again suggests that it does not seek an even distribution in the first instance.

A final argument against the ED reading is evident from the fact that the bankruptcy code contains a separate provision that straightforwardly seeks to accomplish the goal of even distribution among creditors. The preference avoidance provisions of 11 U.S.C. § 547 state that “the trustee may avoid any transfer of an interest of the debtor in property” made “on or within 90 days before the date of the filing of the petition.” The underlying idea is that a debtor should not be permitted to play favorites in determining which creditors should have their debts repaid.<sup>108</sup> Instead, all creditors of the same class should

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<sup>107</sup> *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 852 n.14 (D. Utah 1987).

<sup>108</sup> For a classic case that seems to involve a transfer that was both fraudulent and preferential, see *Twyne’s Case*, 76 Eng. Rep. 809, 810-13 (Star Chamber 1601). There, the debtor owed debts to both Twyne and C. but did not have sufficient assets to cover both debts. He secretly gifted the assets he possessed to Twyne, who allowed the debtor to continue using the assets in question. This transaction reflected both an

receive a distribution of the estate proportionate to what they are owed. Section 547 thus negates preferences among creditors and, in so doing, ensures an equitable distribution among them. Indeed, as one of the foremost treatises on bankruptcy law explains, “preference law . . . restructures transactions *so as to level out the overall treatment received by similar creditors.*”<sup>109</sup> If the purpose of § 547 is to ensure an even distribution, it could not be the purpose of § 548, the fraudulent transfer provision, to do so as well.<sup>110</sup> Leveraging the fraudulent

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unfair preference for Twyne and a fraudulent conveyance, insofar as it was conducted in secret with the intention of hindering C.’s recovery.

<sup>109</sup> 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON, III, NORTON BANKRUPTCY LAW AND PRACTICE § 66:1 (3d ed. 2009) (emphasis added).

<sup>110</sup> *But see In re Bayou Grp.*, 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part*, 439 B.R. 284, 303, 338-39 (S.D.N.Y. 2010) (“Section 548 serves the same policy function as Section 547, which allows the trustee to avoid preferential payments made within ninety days of the bankruptcy to perfectly innocent creditors who were legally entitled to be paid. Both sections represent an equitable determination by Congress that under limited circumstances creditors must share equally in the insolvency, or, in the case of Section 548, the fraud. Section 548 is not a punitive provision designed to punish the transferee, but is instead an equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive fraudulent conveyances.”). Commentators have decried the *Bayou* decision, because it articulates an overly demanding test for establishing good faith. *See, e.g.*, Sullivan, *supra* note 9, at 1623 (“[*Bayou*’s] objective good faith standard contravenes congressional intent, confuses the goals of fraudulent and preferential transfer law, unfairly penalizes savvy investors with actual good faith based on their status alone, demands investors to be more diligent than the SEC itself, and assumes (with the benefit of hindsight) that investors saw the ‘red flags.’”). Thus, two other opinions from the Southern District of New York—*Picard v. Katz*, 462 B.R. 447, 453-57 (S.D.N.Y. 2011) (Rakoff, J.), the Madoff trustee’s billion-dollar fraudulent-transfer suit against the Mets’ owners, and *Gowan v. The Patriot Grp. (In re Dreier LLP)*, 452 B.R. 391 (Bankr. S.D.N.Y. 2011) (Glenn, J.)—have explicitly disagreed with, and so declined to follow, *Bayou*’s determination of the meaning of “good faith.” *See generally* Paul D. Sinclair & Monika Machen, Katz, Dreier Cut into Aggressive Trustees’ Positions, 31 AM. BANKR. INST. J., Feb. 2012, at 48.

More relevant here, the *Bayou* court’s assertion that both § 547 and § 548 have equity as their rationale is problematic for two reasons. First, if it were true, it would render mysterious the different reach-back periods in §§ 547 (ninety days) and 548 (two years); surely the fact of the *bankrupt*’s wrong cannot justify exposing his transferees to a longer reach-back period, which is to say exposing them to an obligation to share more in the losses. Second, if the court is correct as to the rationale for § 548, then its application to Ponzi scheme winners would undercut the reading of “net equity” advanced by the SEC, adopted by Judge Lifland and affirmed by the Second Circuit, *see supra* Part I.B. The *Bayou* court intends that “the transferee [be placed] in the same position as other similarly situated creditors who did not receive fraudulent conveyances.” *In re Bayou Grp.*, 396 B.R. at 827. As applied to the Madoff winners and losers, then, the winners should have no more entitlement, *but also no less*, to Madoff’s estate. This would be the result if, say, all Madoff investors returned all of the money they had withdrawn from their Madoff accounts, and it was then divided among them in proportion to the amount of their investment. But the effect of the net equity decision is to deny winners the status of customers with valid net equity claims; at the same time, winners who can establish their good faith will have only their withdrawn profits clawed back. So, winners who cannot establish their good faith

transfer provision for purposes of seeking equity among Madoff's customers, then, renders the preference avoidance provisions superfluous.<sup>111</sup> Or, put less charitably, it is possible to see Picard's efforts to use the fraudulent transfer provision to pursue clawbacks as an end-run around the shorter reach-back period of a mere ninety days in the preference avoidance provision,<sup>112</sup> in favor of the longer reach-back period of up to six years in the fraudulent transfer provision.<sup>113</sup>

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will come out behind the Madoff losers, while winners who proceeded in good faith will come out ahead. And, there is no mechanism for excluding from recovery those losers who *did* know of the fraud and, perhaps out of an excess of greed, chose to continue riding the Ponzi scheme wave thinking that they could get out before the scheme collapsed. In short, if the avoidance provisions really do seek an equitable distribution of the bankrupt's assets, then the law in this area is in even more disarray than the text accompanying this note suggests.

<sup>111</sup> *But cf.* Clark, *supra* note 94, at 510-13. Clark describes the general rationale for both fraudulent conveyance *and* preference avoidance as "that of Nonhindrance of the enforcement of valid legal obligations against oneself, in connection with transfers of one's property. In summary, then, fraudulent conveyance law embodies a general ideal, in connection with a debtor's transfers of property rights and incurrences of new obligations, of Nonhindrance of creditors." In this way, Clark would seem to interpret both §§ 547 and 548 along the lines of what I have called the AF reading. Nonetheless, Clark subsequently acknowledges that the ideal of Evenhandedness, which underpins preference avoidance, is indeed distinct from the other specifications of the general commitment to Nonhindrance:

It is also possible, however, to view Evenhandedness as a policy independent of, and on a par with, a general ideal of Nonhindrance, and this aspect of the policy has led to its development as a separate topic. While like the other two ideals Evenhandedness specifies the moral duties of a debtor to his creditor, Evenhandedness is also the ideal behind what is referred to as the law of voidable preferences and many cases assume or state explicitly that a preference is not a fraudulent conveyance.

*Id.* at 513.

<sup>112</sup> 11 U.S.C. § 547(b)(4)(A) (2006). At least one court has decried § 547's short statute of limitations when it comes to Ponzi schemes:

For a Ponzi scheme that lasts more than three months, the statute[] . . . does not go far enough. By definition, an enterprise engaged in a Ponzi scheme is insolvent from day one. Thus, *all* transfers to investors in a Ponzi scheme are preferential, not just those made within the three months before bankruptcy. Every transfer prefers the transferee to those investors at the end of the line. The evil of a preferential transfer is that it "unfairly permit[s] a particular creditor to be treated more favorably than other creditors of the same class." All investors in a Ponzi scheme are creditors of the same class, so in theory all should be treated equally. In effect, though, applying section 547 to a Ponzi scheme . . . favors some creditors over others. Under section 547 the creditors who are most preferred are allowed to keep their preferential payments because the transfers were made outside the statutory period . . . The statute simply does not reach the early investors. Thus, applying the statute as written, the court is "compelled to take part in a farce whose result is . . . to take away from those who have little, the little that they have." The equitable solution would be either to apply the statute to all transfers to investors in a Ponzi scheme—without regard to when the transfers were made—or to apply the statute to none of the transfers.



All of this shows that the AF reading is on far firmer ground than is the ED reading. Treatise writers and distinguished jurists seem to agree. Thus, one of the classic bankruptcy law treatises states that “the intent of [fraudulent conveyance statutes] . . . is not to provide equal distribution of the estates of debtors among their creditors; there are other statutes [in bankruptcy] which have that effect.”<sup>114</sup> A leading

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*In re Indep. Clearing House Co.*, 77 B.R. 843, 871 (D. Utah 1987) (citations omitted).

Other commentators have noted that the short reach-back period of the preference avoidance provision might have impelled courts to adopt expansive understandings of the circumstances under which a fraudulent transfer has arisen. *See, e.g.*, Cherry & Wong, *supra* note 15, at 404 (“[B]ecause the typical losing investor nonetheless remains at an unfair disadvantage, courts have sought to rectify the balance . . . [C]ourts have begun to adopt a narrower reading of the good faith defense so as to potentially reach all payments received by an investor from the scheme . . . not just . . . fictitious profits.” (citation omitted)). At least some of these commentators welcome this expansive reading. *See id.* Those who have decried the expansion do so on separation of powers grounds, and not on the fairness-based grounds I adduce here. *See, e.g.*, Sullivan, *supra* note 9, at 1634-35; Lustig v. Weisz (*In re Unified Commercial Capital, Inc.*), 260 B.R. 343, 349-50 (Bankr. W.D.N.Y. 2001) *aff’d sub nom. In re Unified Commercial Capital*, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

[Some] courts . . . appear to believe that a “just” solution to the losses suffered by the innocent investors in a “Ponzi” scheme requires some reallocation of the risks and redistribution of the losses beyond that provided for by Congress in Section 547(b) . . . . [T]he fraudulent conveyance statutes cannot and should not be utilized by courts as a super preference statute to effect a further reallocation and redistribution that should be specifically provided for in a statute enacted by Congress. The Section 548(a) and state law fraudulent conveyance statutes implement a policy of preventing the diminution of a debtor’s estate. The Section 547(b) preference statute implements a principal policy of equality of distribution. By forcing the square peg facts of a “Ponzi” scheme into the round holes of the fraudulent conveyance statutes in order to accomplish a further reallocation and redistribution to implement a policy of equality of distribution in the name of equity, I believe that many courts have done a substantial injustice to those statutes and have made policy decisions that should be made by Congress.

*In re Unified Commercial Capital, Inc.*, 260 B.R. at 349-50.

<sup>113</sup> Section 548 authorizes avoidance of transfers made only in the two years prior to the declaration of bankruptcy. *See* 11 U.S.C. § 548 (2006). However, § 544(b) of the Code allows the trustee to avoid fraudulent conveyances based on state law, 11 U.S.C. § 544(b), and the New York fraudulent transfer provision allows for a six year reach-back period, N.Y. C.P.L.R. § 213 (McKinney 2012). In the case against the Mets owners, Judge Rakoff held that the bankruptcy trustee could proceed against the defendants only upon a theory of actual fraud, as articulated in 11 U.S.C. § 548(a)(1)(A), which limited the reach back period to two years (and the recovery amount to \$384 million, rather than the \$1 billion the trustee had sought). *See Katz*, 462 B.R. at 451. It is not yet clear what effect, if any, this ruling will have on the other Madoff claw back suits and, in particular, on the allowable reach-back period.

<sup>114</sup> 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 289 (rev. ed. 1940) (quoting *In re Johnson*, 20 Del. Ch. 389 (1881) (internal quotation marks omitted)); *see also* Peter L. Borowitz & Richard F. Hahn, *The Troubled Leveraged Buyout: Risks (and Opportunities) Under Fraudulent Conveyance and Other Creditors’ Rights Laws*, in 694 PRACTISING LAW INSTITUTE: CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 51, 53-54 (“In its original form fraudulent conveyance law

bankruptcy law casebook states that the “purpose of fraudulent conveyance law, whatever its form, is simple; it protects a debtor’s unsecured creditors from reductions in the debtor’s estate to which they generally look for their security.”<sup>115</sup> In a First Circuit Court of Appeals decision, then-Judge Stephen Breyer stated that one of the “basic functions” of fraudulent conveyance law is “to see that an insolvent debtor’s limited funds are used to pay *some* worthy creditor,” and not to “determin[e] *which* creditor is the more worthy.”<sup>116</sup> Breyer’s conception has subsequently been endorsed by the Second Circuit Court of Appeals,<sup>117</sup> as well as numerous federal district and bankruptcy courts.<sup>118</sup> In short, according to all of these sources, contemporary law allows fraudulent conveyances to be avoided *because they are fraudulent*, not because they risk creating a disparity between creditors of the same class.

But even if the bankruptcy code was not intended to be used to take money from some innocent Ponzi scheme investors and provide it to others, perhaps we should nonetheless refrain from opposing the clawback actions. After all, any money that a Madoff customer withdrew over and above that which she invested was money that another Madoff customer had deposited. In many cases, sheer luck will have allowed some Madoff investors to come out ahead, while others come out with little or nothing. Why should luck be so decisive, especially if the winners’ “winnings” come directly from the losers’ pockets? Indeed, Picard has relied on precisely this logic in defending the clawback suits to the general public. Yet despite its intuitive appeal, this rationale turns out to be quite problematic.

### III. UNJUST ENRICHMENT AND STOLEN GOODS

In seeking to justify avoidance actions filed against innocent and (allegedly) knowing investors alike, Picard has

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focused exclusively on transfers of a debtor’s property where there was actual evidence of the debtor’s intent to harm its creditors by hiding assets from imminent levy.”

<sup>115</sup> MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY: CASES AND MATERIALS 387 (3d ed. 2006).

<sup>116</sup> Boston Trading Grp. v. Burnazos, 835 F.2d 1504, 1511 (1st Cir. 1987); *see also id.* at 1509 (“[T]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them.”).

<sup>117</sup> *See, e.g., In re Sharp Intern. Corp.*, 403 F.3d 43, 54 (2d Cir. 2005); HBE Leasing Corp. v. Frank, 48 F.3d 623, 634 (2d Cir. 1995).

<sup>118</sup> *See, e.g., In re Jeffrey Bigelow Design Grp.*, 956 F.2d 479, 484 (4th Cir. 1992); *In re Pearlman*, 460 B.R. 306, 312, (Bankr. M.D. Fla. 2011); *In re Apton Corp.*, 423 B.R. 76, 93 (Bankr. D. Del. 2010).

been quite savvy in his choice of language. In a quote to the *Wall Street Journal*, Picard exclaimed that “the people who made money, who got more, have made money at the expense of the people who didn’t.”<sup>119</sup> Putting the point even more starkly, he subsequently described the disparity between winners and losers by stating that, “for more than 20 years, Bernard Madoff stole money from some people and gave it to others.”<sup>120</sup> Echoing this rhetoric, Picard’s lieutenant, David Sheehan, stated that “[t]hose who didn’t get their money back are entitled to get it from those who have it.”<sup>121</sup>

These statements have great intuitive appeal, as they rely upon an implicit analogy to two well-established doctrines—namely, the law of unjust enrichment and the law of stolen goods. For both of these doctrines, one party may be compelled to return money or goods illicitly taken from their original owner, even if the former is completely innocent of the illicit taking. Picard and Sheehan’s rhetoric implies that we should conceive of the winners as the innocent recipients of ill-gotten gains or stolen goods, in which case, compelling the winners to return their “winnings” to the losers would be consistent with the doctrines governing unjust enrichment and stolen goods.

Picard is not alone in seeking to leverage this rhetoric. Both the Securities Investor Protection Corporation and the trustees charged with recovering assets in the wake of other Ponzi schemes have also sought to support clawback suits by analogizing the transfers they seek to avoid to instances of unjust enrichment or stolen goods.<sup>122</sup> It behooves us, then, to

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<sup>119</sup> Michael Rothfeld, *Madoff Investors Brace for Lawsuits*, WALL ST. J., at C1, July 26, 2010, available at <http://online.wsj.com/article/SB10001424052748704719104575389141620473502.html> (internal quotation marks omitted).

<sup>120</sup> *The Madoff Recovery Effort: An Update Call with the Trustee and His Counsel from Baker Hostetler* (Mar. 8, 2011, 3:00 PM), at 1, available at <http://207.58.180.20/document/news/000018-2011-march-8-picard-sheehan-opening-statements-for-march-8-press-call.pdf>; see also Alan Rappoport, *123 Claims Filed over Madoff Payouts*, FIN. TIMES, Dec. 1, 2010, at 25, available at <http://www.ft.com/cms/s/0/0aa84be4-fcdf-11df-ae2d-00144feab49a.html#axzz1os4RzPPa> (quoting from the complaint for the clawback suit filed against a hedge fund operator in which Picard alleges that “[t]he transfers received by the defendant constitute non-existent profits supposedly earned in the account, but, in reality, they were other people’s money . . . .” (internal quotation marks omitted)).

<sup>121</sup> *Madoff Recovery*, *supra* note 120, at 6. Joe Nocera, the *New York Times* columnist, echoes these words in his arguments supporting the clawback suits: “[T]he net winners’ gains came from the pockets of the net losers. That’s how a Ponzi scheme works. If you buy a stolen watch, and its real owner wants it back, don’t you have an obligation to return it?” Joe Nocera, *Suspense Is Over in Madoff Case*, N.Y. TIMES, June 26, 2012, at A23.

<sup>122</sup> Thus, the receiver appointed by the SEC in the Stanford International Bank fraud has sought to recover money from innocent beneficiaries of the Ponzi

consider the force of the analogies. In this Part, I address each of the purportedly analogous doctrines in turn.

### A. *The Law of Unjust Enrichment*

The law of unjust enrichment holds that “[a] person has a right to have restored to him a benefit gained at his expense by another, if the retention of the benefit by the other would be unjust.”<sup>123</sup> An unjust enrichment analysis includes the following inquiries: “(i) Was the defendant enriched? (ii) Was it at the expense of the claimant? (iii) Was it unjust?”<sup>124</sup> An affirmative answer to each of these questions entails that a defendant has been unjustly enriched. Such a defendant will be required to reconstitute the plaintiff, unless the defendant can marshal an established defense.<sup>125</sup>

A recitation of the bare elements of the doctrine of unjust enrichment cannot tell us whether the Madoff winners were in fact unjustly enriched. For one thing, whether the winners’ profits were accrued *at the expense of* the losers turns on whether the losers maintain a claim to the money that the winners received. This is precisely the question under debate. Suppose that the winners and losers invested in Schmadoff’s legitimate investment scheme instead of Madoff’s fraud. Suppose further that the investment scheme, while profitable for many years, suddenly goes bust as a result of an

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scheme by advancing, *inter alia*, a claim that they were unjustly enriched. Receiver’s First Amended Complaint Against Certain Stanford Investors ¶¶ 39-42, Janvey v. Alguire, 846 F. Supp. 2d 662 (N.D. Tex. 2011) (No. 03:09-CV-0724-N), *available at* [http://www.stanfordfinancialreceivership.com/documents/Receivers\\_First\\_Amended\\_Complaint\\_Against\\_Certain\\_Stanford\\_Investors.pdf](http://www.stanfordfinancialreceivership.com/documents/Receivers_First_Amended_Complaint_Against_Certain_Stanford_Investors.pdf). And, the SIPC, in a brief supporting the trustee’s interpretation of net equity, argued that:

[u]nless the fictitious trades in BLMIS are avoided, claimants who were advantaged by the broker’s fraud, that is, investors who received withdrawals from BLMIS that actually consisted of other investors’ money under the guise of investment profits . . . will be allowed to benefit at the expense of other equally innocent investors.

Memorandum of Law of the Securities Investor Protection Corporation in Support of Trustee’s Motion for an Order Upholding Trustee’s Determination Denying “Customer” Claims for Amounts Listed on Last Statement, Affirming Trustee’s Determination of Net Equity, and Expunging Those Objections with Respect to the Determinations Relating to Net Equity at 36, SIPC v. Bernard L. Madoff Inv. Sec. (*In re Bernard L. Madoff Inv. Sec.*), No. 08-01789 (BRL) (Bankr. S.D.N.Y. Oct. 16, 2009), *available at* <http://www.madofftrustee.com/document/dockets/000450-519-memorandum-of-law.pdf>.

<sup>123</sup> Warren Seavey & Austin Scott, *Restitution*, 54 LAW Q. REV. 29, 32 (1938). *See generally id.* at 36-37 (collecting paradigmatic statements of the doctrine).

<sup>124</sup> BIRKS, *supra* note 9, at 39.

<sup>125</sup> *Id.*

extraordinary event that no one could have predicted and that was no one's fault. For example, imagine that a meteor strikes the building where Schmadoff had his offices and destroys the vault where he had stored half of the investors' money in anticipation of a large stock purchase, while the other half was already invested in the market. Although Schmadoff's firm was appropriately insured, insurance does not cover this contingency, and so half of the money investors thought they had is gone. Over the years, some investors withdrew more money than they had deposited, while other investors had not recouped all, or even any, of their principal at the time of the vault's destruction. The former set of investors would have been enriched, but it seems a stretch to say that they were enriched at the expense of the latter, even though their withdrawals have left fewer resources to be distributed among the latter. Similarly, the Madoff winners' withdrawals have also left fewer resources to be distributed among the losers. But why should we think that their "winnings" come at the expense of the losers if we do not think that the Schmadoff winners gain at the expense of the Schmadoff losers?

Even if the Madoff winners (and perhaps the Schmadoff winners, too) have gained at the expense of the losers, it is not at all clear that they have gained *unjustly*. The paradigmatic case of unjust enrichment involves the mistaken payment of a non-existent debt,<sup>126</sup> such as when *A* forgets that she has already discharged her debt to *B* and pays *B* twice. Clearly, the Madoff case is distinct from this paradigmatic case. Other cases involve "failures of consideration, shades of fraud and pressure, and taking advantage of vulnerable people."<sup>127</sup> The second of these factors is most apt here, and it might ground the losers' right to recovery under the following established principle: "If *X* takes *C*'s money without *C*'s consent and gives it to *D*, then *D* becomes indebted to *C* in the sum received."<sup>128</sup> Here, *X* would be Madoff, *D* a winner, and *C* a loser, and the principle would apply so long as

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<sup>126</sup> *Id.* at 5, 73 (referring to this case as "the core of the core" of unjust enrichment doctrine); Dennis Klimchuk, *The Normative Foundations of Unjust Enrichment*, in *THE LAW OF UNJUST ENRICHMENT* 81, 82 (Robert Chambers et al., eds., 2009).

<sup>127</sup> BIRKS, *supra* note 9, at 40 (citing these, along with cases of mistake, as an exclusive list of unjust factors).

<sup>128</sup> *Id.* at 86 (distilling the principle behind the House of Lords's decision in *Lipkin Gorman v. Karpnale Ltd.*, [1991] 2 A.C. 548 (H.L.) (Eng.)). Cf. Zoe Sinel, *Through Thick and Thin: The Place of Corrective Justice in Unjust Enrichment*, 31 OXFORD J. LEGAL STUD. 551, 551 (2011) ("Clearly, one should return what one was not meant to receive and for which one gave nothing in return.").

we were licensed in construing the case as one in which Madoff took the losers' money without their consent.

In response, one might point to an exception to the principle and contend that *D* need not return the money to *C* if *D* received it in exchange for a bona fide purchase. Thus, if an attorney embezzles money from his law firm and uses it to buy himself a lavish dinner at the Ritz, the Ritz need not return any of the proceeds of the meal to the law firm, because it supplied the food and drink in exchange for the money paid.<sup>129</sup> Moreover, this result holds even if the Ritz marks up its prices exorbitantly to ensure that its profit margin is, for example, ninety percent of the purchase price.<sup>130</sup>

Leveraging this exception, one might argue that the Madoff winners are like suppliers of goods who receive ill-gotten gains in a genuine, legitimate exchange. This will not do, however. If Madoff's fraud vitiates the claimant's consent and thereby renders the transfer between a losing investor and Madoff illicit, then so too it vitiates the legitimacy of the exchange between Madoff and the winning investor.

As such, this appears to be a case where the law of unjust enrichment would compel the Madoff winners to return their winnings to the Madoff losers.<sup>131</sup> But it is just at this point that the law of unjust enrichment is on its weakest footing. To be sure, courts have found that defendants must return funds that have been "misdirected from the plaintiff's bank account or trust fund by a fraudulent . . . third party,"<sup>132</sup> even though the defendant bears no responsibility for the fraud. The rationale in these cases emphasizes the *plaintiff's* lack of responsibility for the transfer; the *defendant's* lack of responsibility is taken to be irrelevant.<sup>133</sup> But why should this be? As Kit Barker asks, "Why is the defendant, who is no more causally implicated in events than anyone else, obliged to

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<sup>129</sup> The example is Birk's variation on the *Lipkin Gorman* case. BIRKS, *supra* note 9, at 86.

<sup>130</sup> *Id.*

<sup>131</sup> Assuming, as I am in this Section, that the Madoff winners in question were blamelessly ignorant of the fraud, they would have rights of rescission that protected money withdrawn equal to the principle they had invested. See, e.g., *Katz*, *supra* note 11, at 453-54 (describing the transferee's right of rescission as an antecedent debt of the estate, owed in exchange for the value the transferee had invested with the debtor).

<sup>132</sup> Kit Barker, *The Nature of Responsibility for Gain: Gain, Harm and Keeping the Lid on Pandora's Box*, in *THE LAW OF UNJUST ENRICHMENT* 162 (Robert Chambers et al. eds., 2009) (citations omitted) (citing relevant caselaw).

<sup>133</sup> Barker, *supra* note 132, at 165-66.

remedy the plaintiff's bad luck? Is there not an equally strong case, for example, for compensating the plaintiff . . . from a public fund, rather than looking to private law for a restitutionary remedy?"<sup>134</sup> Indeed, one might make the point more forcefully by arguing that imposing the remedy exclusively on the defendant treats him as a mere means. It "uses the defendant as an instrument in the service of the plaintiff's interests."<sup>135</sup>

One can find two responses to these queries in the scholarly literature on unjust enrichment, but neither is ultimately convincing. First, some have suggested that liability here vindicates not the plaintiff's particular interest but instead "the value of autonomy more generally, a value in which the defendant can be understood to have an interest, no less than the plaintiff. So liability does not treat the defendant as a mere means."<sup>136</sup> The argument seems to be that both the plaintiff and the defendant gain from the imposition of liability insofar as liability vindicates the autonomy of each. But a problem remains. The prospect, or even reality, of gain does not undercut the concern that the defendant is being used as a mere means. Analogously, we might say that, in cases of false conviction, the innocent individual who is punished shares in a benefit that her punishment produces—namely, the general deterrence that will make others less likely to commit a similar crime and that will make the defendant less likely to be victimized by such a crime. Still, the defendant is being treated as a mere means because she is singled out for punishment without cause, even if she, along with others, enjoys the benefit her punishment generates. The defendant serves as an instrument for the gain, even if the gain is one in which she can partake.

A second line of response acknowledges that "there is nothing uniquely, morally significant" about the defendant who is innocent of the fraud from which he gains.<sup>137</sup> Nonetheless, it makes sense to have him "insure" the plaintiff against her loss "because he happens to have an obvious surplus fund" (i.e., the

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<sup>134</sup> *Id.* at 166.

<sup>135</sup> Klimchuk, *supra* note 126, at 97. Klimchuk is trying to rescue Hanoch Dagan's account of unjust enrichment, according to which the doctrine is intended to vindicate the value of autonomy generally. *See, e.g.*, HANOCH DAGAN, *THE LAW AND ETHICS OF RESTITUTION* (2004).

<sup>136</sup> Klimchuk, *supra* note 126, at 97.

<sup>137</sup> Barker, *supra* note 132, at 168 (emphasis omitted).

proceeds deriving from the plaintiff's loss).<sup>138</sup> Along these lines, some allege that a "localised" or "internal" distributive norm operates between the plaintiff and defendant such that fairness, rather than corrective justice, compels return of the money.<sup>139</sup> Regardless of the justificatory force of this reasoning in the standard case of unjust enrichment from a fraud involving a passive defendant, it is not at all clear that it applies convincingly to the Madoff clawback suits. The Madoff winner had a legitimate expectation that his investment would yield returns; therefore his withdrawals might not constitute "an obvious surplus fund." Even those who believe that fairness normally dictates return of the transferred funds recognize an exception where returning the transferred funds would cause the defendant to suffer harm himself.<sup>140</sup> In the Madoff case, the winners relied on the legitimacy of their "winnings"; many of them spent that money thinking that it had been honestly invested and earned.<sup>141</sup> Because the money that winners would be forced to give up is not a surplus, they would be worse off at the end of the day.<sup>142</sup> Put differently, fairness does not necessarily compel the result that arises in the standard case of unjust enrichment, and that the Madoff trustee demands.<sup>143</sup>

In sum, one can say that the winners in the Madoff case have been unjustly enriched only if (i) they have been enriched at the expense of the losers, and (ii) the circumstances of their

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<sup>138</sup> *Id.*

<sup>139</sup> See *id.* at 167 (discussing Dennis Klimchuk, *Unjust Enrichment and Corrective Justice*, in UNDERSTANDING UNJUST ENRICHMENT 111 (J. Neyers et al. eds., 2004) and PETER CANE, RESPONSIBILITY IN LAW AND MORALITY 208 (2002)).

<sup>140</sup> See, e.g., HANOCH DAGAN, UNJUST ENRICHMENT 40 (2004); Barker, *supra* note 132, at 168.

<sup>141</sup> See, e.g., *Madoff's Victims*, MADOFFSCANDAL.COM: THE LARGEST FRAUD THAT THE WORLD HAS EVER SEEN, <http://www.madoffscandal.com/madoffs-victims/> (last visited Mar. 12, 2012) (describing Ira Roth, whose withdrawals from his Madoff account were used to pay for his college tuition and his grandmother's living expenses).

<sup>142</sup> See Barker, *supra* note 132, at 168.

<sup>143</sup> Picard has instituted a hardship program, such that winners who can demonstrate hardship will be excused from having to return their "winnings." See *The Hardship Program*, MADOFF RECOVERY INITIATIVE, <http://www.madoff.com/hardship-program-17.html> (last visited Feb. 24, 2012). The hardship standard that Picard has set is an onerous one. Among the factors Picard lists in order to qualify for the hardship program are the following: "[i]nability to pay for necessary living expenses, such as housing (including loss of home due to foreclosure), food, utilities and transportation"; "[i]nability to pay for necessary medical expenses"; "[i]nability to pay for the care of dependents"; and having "[d]eclar[ed] personal bankruptcy." *Id.* Yet even a more liberal standard would not vitiate the concern raised in the text accompanying this note. Again, the concern is that the defendant may have reasonably relied on the legitimacy of his earnings and so reasonably spent the money that the trustee now claims belongs to the plaintiff. Requiring the defendant to repay that money leaves him worse off even if he is not otherwise financially strapped.



enrichment involve an injustice. But whether or not these conditions apply depends on our understanding of the entitlements of winners and losers alike. The law of unjust enrichment does not illuminate, let alone determine, those entitlements. Only a prior inquiry into the relationship that ought to exist between winners and losers can do so, and I undertake that inquiry in Part V. It will be useful to turn to the law of stolen goods first, however, to see whether it can provide useful insights.

*B. The Law of Stolen Goods*

The rule requiring a person who unwittingly purchases a stolen item to return that item is a fixture of Anglo-American law and is among the legal rules widely known by the layperson and legal sophisticate alike. The “He who hath not cannot give” rule dates back to Roman times,<sup>144</sup> and today it can be found in the UCC,<sup>145</sup> as well as in the UCC’s English counterpart.<sup>146</sup> Yet, notwithstanding the entrenched nature of the rule governing stolen goods, it turns out that there is little to support it, and it is largely irrelevant to the Madoff case in any event.

Why does the law favor the original owner over the good faith purchaser of a stolen item? There are two kinds of rationales adduced in support of the rule—those grounded in considerations of efficiency, and those grounded in considerations of fairness. Under the former, it has been argued that resting priority with the original owner encourages vigilance on the part of would-be purchasers to ensure proper title in the item they are thinking about purchasing.<sup>147</sup> Prioritizing the original owner also deters theft, by making it more difficult for the thief to off-load the fruits of his crime. Yet considerations of efficiency might weigh just as strongly on the other side. We might instead want to encourage vigilance on the part of owners to ensure that they protect their possessions or purchase insurance to cover their losses. And we might want to ensure the fluidity of the market for goods by conferring upon the good faith purchaser a sense of

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<sup>144</sup> See, e.g., BLACK’S LAW DICTIONARY 813 (2nd ed. 1910).

<sup>145</sup> “A purchaser of goods acquires all title which his transferor had or had power to transfer.” U.C.C. § 2-403 (1989).

<sup>146</sup> “[W]here goods are sold by a person who is not their owner, and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had.” The Sale of Goods Act, 1979, § 21(1) (U.K.).

<sup>147</sup> See, e.g., Derek Fincham, *Towards a Rigorous Standard for the Good Faith Acquisition of Antiquities*, 37 SYRACUSE J. INT’L L. & COM. 145, 162 (2010).

repose.<sup>148</sup> So long as he had no reason to know that his purchase had been stolen from someone else, he may rest easy in the belief that it will not be repossessed should its origins be uncovered. For precisely these reasons, the rule operates the opposite way in civil law countries, where good faith purchasers typically enjoy priority and original owners are denied recovery. In sum, the efficiency-based considerations for the rule of stolen goods are hardly decisive in establishing the original owner's priority. But nor are the fairness-based considerations, we shall now see.

Fairness seeks to favor the original owner on the presupposition that the original owner will have imbued the item with more personal meaning than the good faith purchaser. Where the property in question is "personal" under Margaret Jane Radin's conception of that term—being bound up with its original owner's conception of herself—it makes sense to return the item to the original owner.<sup>149</sup> Thus, for example, we can imagine a wedding ring that had been in the original owner's family over multiple generations, and for that reason carries a personal dimension that the good faith purchaser could not appreciate. Fairness would dictate that we privilege the property rights of the original owner, who values the ring for both pecuniary and sentimental reasons, over those of the good faith purchaser, who has only a pecuniary attachment to the ring.

A second fairness-based consideration goes not to the enhanced value the item might hold for the original owner, but instead to the circumstances of its theft. In these instances, the original owner has had the item taken from her against her will.<sup>150</sup> As in cases of Nazi-looted art for example, where the item was stolen as part of a genocidal campaign,<sup>151</sup> we might say that the original owner has sustained not only a material loss but also an expressive injury, given the ethnic animus motivating the crime. In this kind of case, the original owner has borne the greater loss and, in recognition of that fact, fairness would again dictate return of the stolen good.

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<sup>148</sup> See Emily A. Graefe, Note, *The Conflicting Obligations of Museums Possessing Nazi-Looted Art*, 51 B.C. L. REV. 473, 481 (2010).

<sup>149</sup> See Margaret J. Radin, *Property and Personhood*, 34 STAN. L. REV. 957 (1982).

<sup>150</sup> Menachem Mautner, "The Eternal Triangles of the Law": *Toward a Theory of Priorities in Conflicts Involving Remote Parties*, 90 MICH. L. REV. 95, 151-52 (1991).

<sup>151</sup> See, e.g., *Austria v. Altmann*, 541 U.S. 677 (2004) (affirming a judgment in favor of the plaintiff, who sued the Austrian government for the return of six Gustav Klimt paintings that had belonged to her family prior to the Holocaust).

Both of these rationales strike me as no more than presumptively compelling. In many cases, the more personal attachment or the more injurious loss may reside on the side of the original owner. But there will surely be exceptions. For example, if the good faith purchaser had sold his kidney in order to acquire the funds to buy the wedding ring that had been an heirloom in the original owner's family, we might imagine that his fiancée attaches special significance to the ring in light of the sacrifice made to get it for her. This significance might be no less compelling than the significance that the ring holds for its original owner. Similarly, the original owner might have sustained a garden-variety theft, while the good faith purchaser was duped into buying the stolen good as part of a scam that exploits a special vulnerability, causing suffering to the good faith purchaser and members of her group. This is the case in instances of affinity fraud, in which the fraudster preys upon others with whom he shares ethnic or religious ties.<sup>152</sup> In these cases, the good faith purchaser will have been subject to an expressive injury (such as one motivated by ethnic or racial animus) while the original owner was not. In sum, the fairness rationales appear to provide merely presumptive reasons for privileging the original owner, not absolute grounds for doing so.

In any event, it is difficult to see why these rationales should be relevant when we are dealing with a fungible good, such as money. The family ring or Nazi-looted Gustav Klimt painting cannot be shared by two owners, but money can easily be divided between them. So we need not think about privileging the winner or the loser of an investment fraud in the same way that we need to contemplate privileging the original owner or the good faith purchaser for a theft of a unique object.

Moreover, there is a further distinction between a case of stolen goods and financial fraud that is worth underscoring. In the case of a financial fraud like Madoff's, each investor was a potential victim of theft. To return to our two-person Ponzi scheme involving Smith and Jones, consider the following:

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<sup>152</sup> The SEC defines an affinity fraud as fraud that "prey[s] upon members of identifiable groups, such as religious or ethnic communities, the elderly, or professional groups. The fraudsters who promote affinity scams frequently are . . . members of the group . . . . These scams exploit the trust and friendship that exist in groups of people who have something in common." *Affinity Fraud: How to Avoid Investment Scams that Target Groups*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/pubs/affinity.htm> (last modified Sept. 6, 2006).

Although Smith cashed out early and Jones was left exposed, the situation could have proceeded precisely the opposite way, with Jones cashing out early and Smith bearing the loss. Further, it is not simply that either of them *could have been* the victim of fraud. Each *was* the victim of fraud. This is true not only in those cases where winning investors believed they had money left in their Madoff accounts but later learned that they would not recover it based on the bankruptcy court's definition of net equity. Even the investor who had liquidated her account and received exactly the amount she believed she was owed can be said to have been a victim of fraud insofar as she invested her money under false pretenses. Both were the intended "dupees" of a fraudster; that only one of them suffered the pecuniary consequences of having been duped is merely a matter of luck, for which neither bears responsibility. There is, accordingly, a moral equivalence between Smith and Jones, and between any innocent winner and innocent loser in a Ponzi scheme. By contrast, there need not be a moral equivalence between the good faith purchaser of a stolen good and the individual from whom it was stolen; this will especially be the case where the good has changed hands more than once, and the last seller was innocently ignorant of the good's illicit provenance.

In sum, the law of stolen goods derives its rationale from a set of potentially dubious presumptions, and these have little relevance to the relationship between Ponzi scheme winners and losers in any case. Further, even if one were to remain convinced that fairness demands loss sharing among Ponzi scheme winners and losers, it would nevertheless be unfair to proceed with the clawback suits, given that we do not require innocent beneficiaries of other kinds of wrongs to share in the losses that the victims of those wrongs sustain, as we shall now see.

#### IV. OTHER ANALOGOUS DOCTRINES?

The legal response to the Madoff case cannot be assessed in isolation. The Madoff Ponzi scheme collapsed at the same time as—and as a result of—the 2008 financial meltdown. With stock values plummeting, Madoff's customers sought to withdraw their money *en masse*, but Madoff was unable to satisfy all of their claims at once. We know now that the financial crisis was precipitated in no small part by acts of wrongdoing. Fraud itself increased in the years preceding the

meltdown.<sup>153</sup> Moreover, among the acts and events identified to have caused the crisis, instances of recklessness, willful blindness, and exploitation figure prominently.<sup>154</sup> Yet the response to the financial crisis has all but eschewed any grand-scale attempt to compensate those who lost money through no fault of their own. This Part seeks to distinguish the clawback suits against innocent winners in a Ponzi scheme from other restitutionary measures that adversely affect innocent beneficiaries of a corporate or financial wrong. In Part IV.A, I focus on executive compensation, while in Part IV.B I address shareholder losses resulting from corporate or financial wrongs.

### A. *Executive Compensation Clawbacks*

Outside of the avoidance provisions of bankruptcy laws, the only individuals who are *eligible* targets for clawback actions are corporate executives, and only when their companies issue earnings restatements to correct for earlier mistaken earnings reports.<sup>155</sup> More specifically, each of the

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<sup>153</sup> See Page Perry, LLC, *Financial Scams Are Becoming More Common as the Economy Deteriorates*, INVESTMENT FRAUD LAWYER BLOG (Apr. 13, 2009), [http://www.investmentfraudlawyerblog.com/2009/04/financial\\_scams\\_are\\_becoming\\_m.html](http://www.investmentfraudlawyerblog.com/2009/04/financial_scams_are_becoming_m.html) (“The Federal Bureau of Investigation reported that corporate fraud more than doubled from 279 cases in 2003 to 529 in 2007 . . . . The financial frauds include various forms of theft, such as Ponzi Schemes and embezzlement.”).

<sup>154</sup> See, e.g., THE FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT XV-XX (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>155</sup> The focus here is on clawback actions that arise independent of the clawback target’s participation in the underlying wrong. Since 1971, the SEC has enjoyed power to seek restitution from corporate executives or corporations that have engaged in financial fraud, with the inaugural case involving insider trading. *Sec. & Exch. Comm’n v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301, 1307-08 (2d Cir. 1971). Yet, until the 1990s, the rationale for these SEC clawback suits was to deter wrongdoing, and not to distribute the returned money to those whom the insider trading had injured. See Zimmerman, *supra* note 2, at 527-28; *Sec. & Exch. Comm’n v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997) (“Although disgorged funds may often go to compensate securities fraud victims for their losses, such compensation is a distinctly secondary goal.”). Compensation became a primary goal of SEC disgorgement actions “in 1990, when Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act. The Penny Stock Reform Act . . . expressly authorized the SEC to design rules for the distribution of such awards.” Zimmerman, *supra* note 1, at 528 (citations omitted). Further, Section 308 of Sarbanes-Oxley, the “Fair Funds” provision, grants the SEC authority to seek “any equitable relief that may be appropriate or necessary for the benefit of investors.” Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 305(b), 308, 116 Stat. 745, 779 (codified at 15 U.S.C. § 78u(d)(5) (2006)). As Aaron Zimmerman describes,

In the six complete fiscal years since Congress passed the Fair Funds Act, the SEC has brought between 218 and 335 judicial enforcement actions per year. In the 2009 calendar year alone, the SEC distributed over \$2.1 billion to

three federal statutes that permit executive compensation clawbacks developed in response to cases of dramatic financial wrongdoing. In particular, the Sarbanes-Oxley Act of 2002 (SOX)<sup>156</sup> was passed in the wake of the Enron and Worldcom scandals,<sup>157</sup> the Dodd-Frank Act of 2010 (Dodd-Frank)<sup>158</sup> was passed in the wake of the subprime mortgage crisis and ensuing financial meltdown in 2007 and 2008,<sup>159</sup> and the Emergency Economic Stabilization Act of 2008 (EESA)<sup>160</sup> was passed in conjunction with the bailout program that the financial meltdown necessitated.<sup>161</sup> Under each statute, the triggering event is a finding that the corporation in question issued a materially inaccurate earnings statement.<sup>162</sup> A further triggering event occurs under Dodd-Frank upon a finding that the corporation otherwise materially failed to comply with a federal securities reporting regulation.<sup>163</sup>

The scope of each clawback provision varies: SOX restricts its clawback provisions to the corporation's CEO and CFO.<sup>164</sup> EESA permits clawing back compensation from the CEO and the next twenty highest paid executives.<sup>165</sup> And Dodd-Frank, the most expansive of the three, subjects any executive of the corporation to a clawback action.<sup>166</sup> On the other hand, Dodd-Frank contemplates a less severe clawback than does either SOX or EESA. Dodd-Frank restricts the clawback amount to that in excess of what the executive would have

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investors—more than twice as much as the amount the SEC collected between 1984 and 1992.

See Zimmerman, *supra* note 1, at 529-30 (citations omitted).

<sup>156</sup> Sarbanes-Oxley Act of 2002, Pub. L. Nos. 107-204, 116 Stat. 745.

<sup>157</sup> See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2003).

<sup>158</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>159</sup> See William E. Cohen, *Foreword to DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* ix (2010).

<sup>160</sup> Emergency Economic Stabilization Act of 2008, div. A, Pub. L. No. 110-343, 122 Stat. 3765.

<sup>161</sup> See, e.g., Sandra Seitman, Note, *Uncle Sam's New Piggy Bank: Confronting Crisis Through TARP and Federal Oversight*, BUS. L. BRIEF 53, 53 (Fall/Winter 2009-2010).

<sup>162</sup> Sarbanes-Oxley Act of 2002, § 304(a); Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954; Emergency Economic Stabilization Act of 2008, § 11(b)(3)(B).

<sup>163</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954.

<sup>164</sup> See, e.g., Joseph E. Bachtelder III, *Clawbacks Under Dodd-Frank and Other Federal Statutes*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (June 9, 2011, 9:14 AM), <http://blogs.law.harvard.edu/corpgov/2011/06/09/clawbacks-under-dodd-frank-and-other-federal-statutes/>.

<sup>165</sup> See *id.*

<sup>166</sup> See *id.*

earned under the correct earnings statement,<sup>167</sup> while both SOX and EESA permit recovery of all of the incentive-based compensation belonging to the targeted executive.<sup>168</sup> The reach-back period under Dodd-Frank is the three years preceding the reporting error or failure, while it is twelve months under SOX and there is no specified reach-back period under EESA.<sup>169</sup>

Importantly, these statutes permit clawbacks independently of whether the targeted individual bears a culpable connection to the triggering event.<sup>170</sup> Each inflicts its clawback measures on both “innocent” and culpable executives alike.<sup>171</sup> One might then think that these statutes, similar to the Ponzi scheme clawback actions, stand for the proposition that an individual ought not profit from another’s wrongdoing, whether or not that individual is culpable of the wrongdoing. Nonetheless, there are significant differences between the executive clawback statutes and the Ponzi scheme clawback cases.

As compared with the Ponzi scheme clawbacks, executive clawbacks are at once more compelling and less harsh. Even in cases where the executive did not participate in the false or fraudulent financial accounting, one could argue

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<sup>167</sup> See *id.* A separate provision of Dodd-Frank applies to failed financial companies and targets “any current or former senior executive or director substantially responsible for the failed condition of the covered financial company” for a clawback of “any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.” Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 210(S) (2010). Since this provision contemplates only those officers or directors who bear a culpable connection to the company’s failure, I do not consider it further.

<sup>168</sup> For the relevant provision, see Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 730 (2011).

<sup>169</sup> See generally Bachelder, *supra* note 164.

<sup>170</sup> See, e.g., Sec. & Exch. Comm’n v. Jenkins, No. 09-CV-0510-PHX-RJB, slip op. (D. Ariz. Nov. 16, 2011), available at <http://www.wlrk.com/docs/SECvJenkins09-cv-1510-136.pdf> (holding that the SEC may claw back executive compensation even when the executive in question was not guilty of the misconduct that necessitated the restatement); Ropes & Gray, *Court Says Sarbanes-Oxley Allows “Clawbacks” of Executive’s Bonuses*, ALERTS & LEGAL UPDATES, <http://www.ropesgray.com/files/Publication/09095ca9-bef7-49e2-aa9d-45eab883df2f/Presentation/PublicationAttachment/6fc9ecd8-5f53-45bc-89dc-48b37b701ba7/06142010TaxBenefitsAlert.pdf> (last visited Mar. 12, 2012); Liz Skola, *The Dodd-Frank Act Requires Publicly-Traded Companies to Adopt Compensation Clawback Policies*, SECURITIES LITIGATION BLOG (Aug. 5, 2010, 9:05 AM), <http://securities.litigation.alston.com/blog.aspx?entry=3869> (“The recent no-fault interpretation of the Sarbanes-Oxley clawback is codified in the Dodd-Frank Act clawback statute.”); Bachelder, *supra* note 164 (“EESA § 111(b)(3)(B) contains no provision limiting it to cases of misconduct.”).

<sup>171</sup> For the view that an executive might not be innocent of a corporate wrong even if she neither participated in, knew about, or was obligated to know about, the wrong, see Amy J. Sepinwall, *Guilty by Proxy: Expanding the Boundaries of Responsibility in the Face of Corporate Crime*, 63 HASTINGS L.J. 411, 435-45 (2012).

that restitution of the excess compensation—i.e., the incentive-based pay that used the falsely inflated figures as the basis for calculating the executive's bonuses, etc.—is nonetheless warranted. Under Dodd-Frank, for example, the executive clawback only rectifies an over-payment and returns the executive to the position she would have occupied had the corporation's accounting been accurate from the start.<sup>172</sup> Thus, she retains whatever financial rewards are owed to her by virtue of what the company did in fact earn—unlike the winning Ponzi scheme investor, who is forced to return all of her profits.

Further, even the more severe clawbacks that SOX and EESA permit—where the executive may be compelled to return all of her incentive-based pay—appear more justifiable than do the Ponzi scheme clawbacks. For one thing, the executive faces a shorter reach-back period than does the Ponzi scheme investor.<sup>173</sup> Moreover, the executive may not feel the sting of any clawback she faces, since corporations are permitted to insure their officers and directors against clawbacks at the shareholders' expense, such that the insurance policy would cover the executive's obligations to return money pursuant to a successful clawback action.<sup>174</sup> By contrast, Ponzi scheme investors cannot insure their investments against fraud.

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<sup>172</sup> Usha Rodrigues puts the point nicely: "If you get a bonus because you meet a goal, and it later turns out that the goal wasn't really met because someone messed with the numbers, then you need to give the money back. Even if you didn't do anything wrong, you didn't really earn that money." Usha Rodrigues, *Clawbacks, Outrage, and Interpretation*, CONGLOMERATE (Aug. 10, 2009), <http://www.theconglomerate.org/2009/08/clawbacks-outrage-and-interpretation.html> (internal quotation marks omitted).

<sup>173</sup> More specifically, the reach back period is no more than three years under any of the federal statutes for the executive, while state law permits avoidance of a fraudulent transfer up to six years prior to the scheme's collapse. *See supra* notes 168-169 and accompanying text. State law follows one of two forms—the Uniform Fraudulent Conveyances Act (UFCA) or Uniform Fraudulent Transfers Act (UFTA). There is no uniform reach-back period among UFCA states, though the range is between two and six years; the UFTA provides a four-year reach-back period. *See White, supra* note 88, at 358-59.

<sup>174</sup> Reynolds Holding & Una Galani, *Pushing Back on Clawbacks*, N.Y. TIMES, Dec. 19, 2011, at B2, *available at* <http://www.nytimes.com/2011/12/20/business/pushing-back-on-clawbacks.html>. For example, the FDIC sued three executives at Washington Mutual, the failed bank, seeking to recover \$900 million from them on the allegation that they took excessive risks in order to reap short-term profits. *See, e.g.*, Louise Story, *Ex-Bank Executives Settle F.D.I.C. Lawsuit*, N.Y. TIMES, Dec. 13, 2011, at B5, *available at* <http://www.nytimes.com/2011/12/14/business/ex-bank-executives-settle-fdic-suit.html>. The executives ended up settling for \$64 million, but they paid only \$400,000 of that out of pocket; the remainder was covered by their clawback insurance. *See id.* Corporations and insurance companies seek to justify the insurance coverage by arguing that the clawback provisions are intended for restitutionary, and not punitive, purposes, and so it doesn't matter whether the returned money comes



In any event, even while financial regulators are permitted to pursue executive clawbacks, this is a remedy that commentators revile<sup>175</sup> and that even the SEC regulators seem to shun.<sup>176</sup> Although companies issued 4609 earnings restatements between 2006 and 2009, the SEC exercised its Sarbanes-Oxley authority to seek executive clawbacks in only eleven instances.<sup>177</sup> While Dodd-Frank's clawback provisions were meant to increase the number of such actions by allowing

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from the executive's pocket or instead that of the insurance company. *See id.* Their position would seem to overlook the deterrent aspect of clawbacks, which can succeed only if the executive personally suffers a pecuniary consequence as a result of her company's mistaken statements.

<sup>175</sup> *See, e.g.,* Larry Ribstein, *Punishing Innocent Executives: SOX's Litigation Time Bomb Goes Off*, IDEOBLOG (July 22, 2009 11:53 AM), <http://busmovie.typepad.com/ideoblog/2009/07/punishing-innocent-executives-soxs-litigation-time-bomb-goes-off.html>; Russell G. Ryan, *The SEC vs. CEO Pay*, WALL ST. J., (Aug. 4, 2009), available at <http://www.chline.wsj.com/article/SB10001424052970204619004574324511579902986.html>.

<sup>176</sup> *Cf.* Manning G. Warren III, *Equitable Clawback: An Essay on Restoration of Executive Compensation*, 12 U. PA. J. BUS. L. 1135 (bemoaning the under-utilization of a common law doctrine that would allow private individuals seeking forfeiture of compensation as a remedy to sue executives who had breached their fiduciary duties).

<sup>177</sup> *See, e.g.,* Fried & Shilon, *supra* note 168, at 731. The SEC took action against transgressing corporations in a number of notable cases of corporate wrongdoing. In these cases, the SEC filed complaints against executives implicated in the wrongdoing but declined to pursue clawbacks. *See, e.g.,* Complaint at 1-2, Sec. & Exch. Comm'n v. Dell Inc., No. 1:10-cv-01245 (D. D.C. July 22, 2010), available at <http://www.sec.gov/litigation/complaints/2010/comp21599.pdf> (SEC's action against Dell Computers, its CEO, and its CFO for overstating earnings between 2002 and 2006); *see also* *Taking Away Dell's Cookie Jar*, ECONOMIST ONLINE (July 23, 2010, 5:58 PM) [http://www.economist.com/blogs/newsbook/2010/07/dells\\_sec\\_settlement](http://www.economist.com/blogs/newsbook/2010/07/dells_sec_settlement). Dell agreed to pay a penalty of \$100 million to settle SEC charges that it "manipulated its accounting over an extended period to project financial results that the company wished it had achieved." Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Dell and Senior Executives with Disclosure and Accounting Fraud (July 22, 2010), available at <http://www.sec.gov/news/press/2010/2010-131.htm> (citation omitted) (internal quotation marks omitted). The CEO and CFO each "agreed to pay a \$4 million penalty to settle the case without admitting or denying wrongdoing, but didn't return any pay," which implies that this was not a true "clawback." Kara Scannell, *Clawbacks Divide SEC*, WALL ST. J., Aug. 7, 2010, at B3, available at <http://online.wsj.com/article/SB10001424052748703988304575413671786664134.html>.

Similarly, in a case brought by the SEC against Hank Greenberg, former CEO of AIG, the SEC alleged that under Greenberg's leadership AIG "faced a number of financial challenges that, had they been properly reported or accounted for, would have exposed significant missteps in AIG's operations and caused the company to miss certain key earnings and growth targets." Complaint at 46, Sec. & Exch. Comm'n v. Greenberg, No. 09 Civ. 6939 (S.D.N.Y. 2009), available at <http://online.wsj.com/public/resources/documents/SECcomplaintgreenberg806.pdf>. The SEC complaint sought disgorgement of ill-gotten gains and civil penalties pursuant to Section 21(d)(3) of the Exchange Act (15 U.S.C. § 78u(d)(3) (2010)) but, of particular relevance here, did not seek to clawback any incentive-based compensation, even though the SEC had the authority to do so under Section 304 of Sarbanes-Oxley. *Id.* at 46; *see also* Stephen Bainbridge, "Unlike French wine, fraud cases don't get better with age," PROFESSORBAINBRIDGE.COM (Aug. 11, 2009, 12:19 PM), <http://www.professorbainbridge.com/professorbainbridgecom/2009/08/unlike-french-wine-fraud-cases-dont-get-better-with-age.html>.

both shareholders and the SEC to litigate them, this aspect of Dodd-Frank has met substantial criticism<sup>178</sup> and has not been invoked even in cases involving the financial institutions whose failures brought the global markets to the brink of collapse.<sup>179</sup>

Finally, even if executive clawback actions were to become commonplace, they would still be a far cry from *investor* clawback actions, the tool of choice in the recovery efforts of the Madoff trustee.<sup>180</sup> The difference arises, at least in part, because unlike the innocent Ponzi scheme investor, the executive cannot plausibly contend that she reasonably relied on the veracity of the earnings statement and, in turn, the legitimacy of her bonus payment for the year in question. The

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<sup>178</sup> See, e.g., Donald Delves, *Clawback Requirement Removes Board Discretion*, FORBES (July 14, 2009, 10:09 AM), available at <http://www.forbes.com/sites/donaldelves/2011/07/14/clawback-requirement-removes-board-discretion/>. Delves argues that clawbacks are ill-advised because they may make accounting departments less likely to uncover errors as employees within these departments will fear retaliation from the CEO who is forced to return incentive-based pay. *Id.* Alternatively, Delves argues that clawbacks may just encourage boards to structure executive pay in a way that does not key it to the company's performance. *Id.* Such board action would run counter to Dodd-Frank's goal of aligning the interests of the executive and her corporation. Greg Michaels, *G20 Leaders Have The Right Idea*, DEALBREAKER (Sept. 16, 2009, 10:17 AM), <http://dealbreaker.com/2009/09/g20-leaders-have-the-right-idea/> (offering the tongue-in-cheek suggestion that politicians zealous about clawbacks should consider passing legislation that would allow for recoupment of a politician's salary in the event that her successor inherits problems for which she bears responsibility).

<sup>179</sup> Thus,

James E. Cayne, the former chief executive of Bear Stearns, still lives in his \$28.24 million apartment at the Plaza Hotel; Joseph J. Cassano the former chief executive of A.I.G. Financial Products, kept more than \$100 million in compensation; and E. Stanley O'Neal, who was the chief executive of Merrill Lynch, retired with a pay package valued at more [than] \$300 million.

Steven M. Davidoff, *In F.D.I.C.'s Proposal, Incentive for Excessive Risk Remains*, N.Y. TIMES (DEALBOOK) (Apr. 12, 2011, 6:00 PM), <http://dealbook.nytimes.com/2011/04/12/in-f-d-i-c-s-proposal-incentive-for-excessive-risk-remains/>.

<sup>180</sup> The law does prohibit a corporation from issuing dividends if it is insolvent, or if the distribution would make it so. See Clark, *supra* note 94, at 554-60. So, shareholders are prospectively barred from receiving funds that would hinder repayment of the corporation's creditors. But a prospective bar on receiving a profit to which one is not affirmatively entitled is a far cry from a claim that one must return a received profit to which one legitimately believed oneself entitled. In any event, there are a number of ways in which the corporation can circumvent the bar, as Clark details. *Id.* at 556-58. Shareholders might well receive profits that would diminish the assets available for distribution to the corporation's creditors. Further, the circumstances under which these profits would be subject to clawback are far more constrained than the general clawback provisions. See *id.* at 558-59 n.154 (There are "provisions in corporate laws specifically stating the conditions under which stockholders may be liable to corporate creditors for improper dividends received . . . . Some of these provisions are clearly more lenient than those applicable to the ordinary fraudulent transferee or grantor, e.g., provisions immunizing from any duty to disgorge dividends those stockholders who were ignorant of the impropriety of the dividends, even when the dividends were paid while the corporation was insolvent." (citation omitted)).

executive is not a disinterested party without access to the relevant financial records, who simply takes the statements and the money that they engender at face value.<sup>181</sup> This is not to suggest that there is an implicit kind of culpability that the executive bears—i.e., negligence or a failure of due diligence—which justifies the clawback. The executive may be genuinely and permissibly ignorant of the financial errors. Still, it is her corporation, and if its earnings statements contain errors, she should be denied the benefits of the mistake.<sup>182</sup>

Instead, a more promising parallel to the Ponzi scheme clawback case is the circumstance in which an innocent shareholder suffers pecuniary consequences as a result of a wrong committed by the corporation.

### B. *Shareholder-Funded Restitution*

Two general kinds of cases occur where shareholders appear to suffer pecuniary consequences as a result of corporate conduct of which they are innocent. The first is the garden-variety case where the corporation faces a fine or damages award and paying it will lower share value. Though the shareholder thereby incurs a potential loss, this is not a true clawback because the shareholder is not being asked to return money that she had already received. Nonetheless, it is worth examining this case because one might think it represents a strand of doctrine where innocent investors suffer in order to defray the losses of the victims of another's wrong—in this case, the corporation's. Accordingly, it is possible that this example could provide support for clawbacks targeting innocent Ponzi scheme investors. The second kind of case involves straightforward shareholder clawbacks and arises

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<sup>181</sup> One way to put the difference between the executive's relationship to her company's financial performance and the winning Ponzi scheme investor's relationship to the actual finances of the scheme would be to note that the latter is an "arm's length bargain," while the former is not. *See, e.g.,* *Merrill v. Abbott (In re Universal Clearing House)*, 77 B.R. 843, 862 (D. Utah 1987) (stating that the test for good faith "is whether the transaction in question bears the earmarks of an arm's length bargain") (citation omitted). Madoff himself insisted that his investors lacked both the financial wherewithal and the means to have uncovered the fraud: "Although I explained the Strategy to them they were not sophisticated enough to evaluate it properly . . . . They were not in a position to perform the necessary due diligence and did not have access to necessary financial info or records." *See* Toobin, *supra* note 8, at 15 (internal quotation marks omitted); *see also id.* at 19.

<sup>182</sup> *Cf.* Sepinwall, *supra* note 171, at 434 (providing an account that would hold executives responsible for corporate wrongs independent of whether the executives satisfy the traditional hallmarks of individual culpability).

when an insolvent corporation has undergone a leveraged buyout. Here, the creditors can seek to reclaim money that the corporation's former shareholders received in selling their shares to the corporation's management-*cum*-owners in the leveraged buy-out (LBO) process.

### 1. Consequences to Shareholders of Corporate Wrongdoing

When a corporation finds itself faced with a financial penalty or significant damages judgment, shareholders might see the value of their shares drop.<sup>183</sup> This might seem unfair in light of the traditional separation between ownership and control, which entails that shareholders have no say over the corporation's day-to-day activities<sup>184</sup> and therefore no available means to prevent the wrongful conduct that precipitates a penalty or judgment. Moreover, the unfairness would be even more apparent in cases where those who hold shares at the time of redress purchased their shares after the wrongdoing had occurred but at a price that did not reflect the possibility that the corporation might face the specific penalty or judgment in question—for example, because the corporate wrong had not been disclosed or even discovered at the time the investor purchased her shares.

To make matters more concrete, consider fraud-on-the-market cases, where the corporation misstates its financial situation and paints a rosier picture than is warranted. In light of the fraudulent statement, share prices rise. To take advantage of the rise in share price, some investors holding shares in the corporation choose to sell, and those who buy the shares then pay an artificially inflated price. When the fraud comes to light, those who bought the shares at an inflated price will sue the *corporation* for damages, rather than the ex-shareholders who profited from the corporation's fraud. If the buying shareholders prevail in their suit, it is the corporation's current shareholders—who might well include the plaintiffs in

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<sup>183</sup> See, e.g., V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1495 (1996) ("Imposing sanctions on a corporation for the acts of its managers or employees presumably decreases the corporation's net worth. Shareholders [. . .] bear the brunt of such a decrease . . .") (citation omitted). Cf. Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 349 (1996) (addressing criminal fines, and arguing that "in the case of a corporation, the burden of a punitive award will fall primarily on the shareholders, most of whom usually have no connection to the wrongdoing in question.").

<sup>184</sup> The classic text articulating this conception of the corporation is ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

the suit!—who will suffer, at least if the corporation's share price drops as a result.<sup>185</sup>

One might then be inclined to say that the SEC's actions here require innocent parties to contribute to defraying the losses of the victims of a wrong, in much the same way that innocent Ponzi scheme "winners" are made to contribute to defraying the losses of the "losers" of the Ponzi scheme. But there are important distinctions. For one thing, it's not clear that those who own shares at the time the corporation is subject to the penalty or judgment do in fact sustain a loss. The company's share price might take a dip, but unless the shareholder is compelled to sell in the immediate aftermath of the penalty's imposition, this may represent only a paper loss. Second, shareholders enjoy limited liability; the most any shareholder can lose is the amount of her investment. By contrast, a Ponzi scheme winner who no longer has the money subject to the clawback can, in principle, have her wages garnished or assets seized in order to satisfy the trustee's claims against her. Third, if the company is forced to disgorge only the funds corresponding to the total amount by which the share value was artificially inflated, and without incurring an additional financial penalty, then the current shareholders come to occupy a position no worse than the one they would have occupied had the fraud never occurred. Finally, it is not the loss in share value that compensates the corporation's victims. The money shareholders lose is not the same money that helps to make the victims whole. Indeed, the drop in share price may correspond only very loosely to the fine or damages award that has been imposed on the corporation.<sup>186</sup> For all of these reasons, cases where innocent shareholders sustain a loss in share value as a result of the corporation's restitutionary or compensatory obligations are vastly different from those faced by innocent investors in the Madoff clawback actions, who may be compelled to *return* money that they legitimately thought was theirs in order to compensate the Madoff losers. As such, innocent shareholders in these cases do not face the unfairness that the innocent targets of a Ponzi scheme clawback suit face. In fact, it is not clear that the former face any unfairness at all.

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<sup>185</sup> See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 73 (2011).

<sup>186</sup> This would be the case if, for example, analysts project that the corporation stands to earn significant profits in the coming quarters and these projections offset the reduction in share price caused by the penalty.

## 2. Shareholder Clawbacks in the Wake of a Leveraged Buyout

There is, however, one type of case where a shareholder *can* be required to return money she made in the market—namely, where she has sold her shares as part of an LBO and the target corporation goes bankrupt shortly thereafter. In a typical LBO, management privatizes a publicly traded corporation by buying back all of the outstanding shares and delisting the corporation. In order to purchase the outstanding shares, management often borrows money from a third-party—e.g., a bank—and secures its loan with the target corporation's assets, thereby increasing the target corporation's liabilities to the potential detriment of the corporation's existing creditors.<sup>187</sup> As one commentator explains, the corporation's "new debt is likely to be senior secured debt. Thus, by definition, LBOs adversely affect existing creditors of the company by reducing the assets available for the satisfaction of obligations owed to them."<sup>188</sup>

In the event that the acquired corporation becomes insolvent shortly after the buyout, the question arises as to whether the share purchases constituted fraudulent transfers, such that a bankruptcy trustee would be permitted to seek to claw back the money that the former shareholders received when they sold their shares to management.<sup>189</sup> Some commentators and courts have argued that the fraudulent transfer provisions should not extend to the LBO context.<sup>190</sup> Nonetheless, the vast majority of courts have approved the use of clawback suits against former shareholders in this context.<sup>191</sup>

Requiring former shareholders to return money in the wake of the insolvency of a corporation in which they no longer

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<sup>187</sup> See, e.g., Robert J. White, *Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code—Like Oil and Water, They Just Don't Mix*, 1991 ANN. SURV. AM. L. 357, 359, 362 & n.29 (1992); Borowitz & Hahn, *supra* note 114, at 67, 70-71.

<sup>188</sup> Kathryn V. Smyser, *Going Private and Going Under*, 63 IND. L.J. 781, 786 (1987-1988).

<sup>189</sup> In addition to pursuing clawbacks against the former shareholders, the bankruptcy trustee could also target the lending bank, which has been "arguably enriched at [the] creditors' expense," Franci J. Blassberg & John M. Vasily, *The Lender's Perspective on Leveraged Acquisitions*, 676 PLI/Corp 69, 127 (1990).

<sup>190</sup> See, e.g., *Kupetz v. Wolf*, 845 F.2d 842, 848 (9th Cir. 1988); Baird & Jackson, *supra* note 96, at 834.

<sup>191</sup> See generally Borowitz & Hahn, *supra* note 114, at 78 (noting that "the applicability of fraudulent conveyance law, as currently enacted, to leveraged buyouts is clear, and the vast majority of courts to have considered the issue have so held" and collecting representative cases). For a scholarly defense of this doctrinal development that seeks to counter Baird and Jackson's arguments (see *supra* note 94), see generally Smyser, *supra* note 188.

hold shares might seem like the height of unfairness—both because the shareholders had presumably given “fair value” in the form of their ownership shares and because the shareholders appear to be innocent of the conduct leading to the acquired corporation’s bankruptcy. As such, we might think that there are relevant similarities between this set of clawbacks and the clawbacks innocent investors in a Ponzi scheme face. A closer look, however, reveals important differences.

First, there need be no relationship between the price at which the shareholders sell their shares and the fair market value of the shares. In a barely solvent corporation, for example, the price management is willing to pay may be keyed to the amount of the loan it can secure, rather than the value of the equity interest in the company. The bank might determine the loan amount without regard to the corporation’s already existing debt. After all, the bank will enjoy priority over existing creditors; as long as the target corporation can secure the *bank’s* loan, the bank has no reason to concern itself with the corporation’s existing obligations.<sup>192</sup> Thus, in a world without shareholder clawbacks, an LBO would be attractive to a “buyer, seller and third party lender precisely because it [would] allow[] all parties to the buyout to shift some portion of the risk of loss associated with their investment in the company to the ‘investors’ in the company who are not involved in the buyout—the other creditors.”<sup>193</sup> This is especially true in the case where the target corporation is already financially troubled, since the shareholders couldn’t readily sell their shares on the secondary market. An LBO thereby provides them with a way both to obtain more money for their shares than they otherwise could, and to “withdraw[] their capital from exposure to total loss in the event the company [were to go] bankrupt.”<sup>194</sup> Moreover, unlike the case in which the corporation incurs more debt to fund an entrepreneurial activity that might eventually be profitable, “a leveraged buyout involves a transaction in which the corporate debtor pledges valuable assets ‘without getting anything in return’ because the loan proceeds are used to pay the selling shareholders.”<sup>195</sup>

Further, the existing shareholders are not without the power to promote, or even mandate, the LBO. In the process,

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<sup>192</sup> See Smyser, *supra* note 188, at 798.

<sup>193</sup> *Id.* at 799.

<sup>194</sup> *Id.* at 798.

<sup>195</sup> *Id.* at 803.

the existing shareholders effectively jump the queue that would exist in the event of a bankruptcy, given that the shareholders' equity interest in the company is subordinate to the claims of the company's creditors. Had the public corporation gone bankrupt, the shareholders would have been able to claim only the value remaining after creditors had been paid; by forcing the corporation to buy back the shareholders' stock before the company declares bankruptcy, the shareholders enjoy a priority over the company's creditors that they are not entitled to.

The role shareholders play in an LBO, then, is not like the role innocent winners play in a Ponzi scheme. Instead, the shareholders' role more closely resembles the role played by a group of Ponzi scheme investors who, knowing of the fraud and seeing the scheme approach the brink of collapse, encourage its operator to find new investors or seek to recruit new investors themselves.<sup>196</sup> These investors participate in the scheme in a way that makes them complicit in it;<sup>197</sup> they hardly count as innocent winners.<sup>198</sup> It does not seem at all unfair to require such accomplices to return any money they have withdrawn. Doing so is consistent with the classic dictate that an individual may not profit from her own wrongdoing<sup>199</sup> but instead must redress her victims.<sup>200</sup> In a similar vein, it is not untoward to ask the former shareholders of an LBO to return the money they received from selling their shares where they encouraged, or perhaps even directed, the sale. Again, all of this suggests that the typical shareholders in an LBO are

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<sup>196</sup> This is the role that Sonja Kohn, an Austrian banker, is alleged to have played in the Madoff Ponzi scheme. See, e.g., Diana B. Henriques & Peter Lattman, *Madoff Trustee Seeks \$19.6 Billion From Austrian Banker*, N.Y. TIMES (DEALBOOK) (Dec. 10, 2010, 12:22 PM), <http://dealbook.nytimes.com/2010/12/10/madoff-trustee-seeks-19-6-billion-from-austrian-banker> (“[A]ccording to the complaint [Picard filed against Kohn], she knowingly raised billions of dollars in cash to sustain Mr. Madoff’s fraud in exchange for at least \$62 million in secret kickbacks . . .”).

<sup>197</sup> See, e.g., Model Penal Code § 2.06(3) (1985) (stating that a person is criminally liable as an accomplice if “(a) with the purpose of promoting or facilitating the commission of the offense, he, (i) solicits [the] other person to commit it, or (ii) aids or agrees or attempts to aid such other person in planning or committing it, or (iii) having a legal duty to prevent the commission of the offense, fails to make proper effort [to prevent it]”).

<sup>198</sup> *But cf. In re Sharp Int’l Corp.*, 403 F.3d 43 (2d Cir. 2005) (finding no lack of good faith where bank knew that Ponzi scheme operator was recruiting new investors to raise funds to repay bank, because bank did not encourage the conduct and bank had no duty to notify the recruited investors that they were going to be duped).

<sup>199</sup> See, e.g., *Riggs v. Palmer*, 115 N.Y. 506, 506 (1889) (denying grandson his inheritance because he killed his grandfather precisely in order to benefit from the provisions of the deceased’s will). For an extended discussion of the case, see RONALD DWORKIN, *LAW’S EMPIRE* 15-20, 130-31 (1986).

<sup>200</sup> See 1 HILLIARD, *supra* note 1, at 83.



situated differently from the innocent investors in a Ponzi scheme.<sup>201</sup> From the now well-established practice of clawing back money from the investors in the LBO context, then, we cannot infer anything about the justifiability of clawbacks against innocent Ponzi scheme winners.

## V. EXPANDING RESTITUTION

In Part II, I argued that only a very strained reading of the fraudulent transfer provisions would support clawing back money from innocent Ponzi scheme investors, and in Parts III and IV, I sought to establish that no other doctrine permits reclaiming money from the innocent beneficiaries of a wrong, whose profits cannot be construed as a windfall and who reasonably relied on the authenticity of their earnings. Therefore, the clawback suits against innocent winners in a Ponzi scheme are anomalous. These winners incur restitutionary obligations that the law does not impose on other innocent beneficiaries of a wrong.

At this point, one could seek to repudiate clawback suits altogether, arguing that if we are not prepared to have the innocent beneficiaries of wrongdoing retribute the wrongdoing's victims across the board, we should not do so in the Ponzi scheme context alone. Instead, this Part adopts the opposite approach, arguing that we should recruit all innocent investors in our attempts to make the victims of financial fraud whole in

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<sup>201</sup> But what about the former shareholder who did nothing to encourage, let alone direct, the leveraged buyout, and who did not know and had no reason to know that the company would be over-leveraged if the LBO were to occur? Is she not in a position that is the moral equivalent of the innocent Ponzi scheme winner? It strikes me that even here there is firmer justification for a clawback against the shareholder than against the winner, for as a result of the LBO the shareholder succeeds in enjoying a higher priority than the company's creditors, even while the creditors would have had a higher priority than the shareholder had both still had an interest in the company at the time of its bankruptcy. By contrast, the winner has a priority equal to that of the loser, and so at least cannot be accused of having jumped the queue, as it were. Nevertheless, even if the shareholder in question has played no role in encouraging the LBO, and even if we set aside the concern about her enjoying undue priority over the corporation's creditors, it is not clear that a clawback action against *her* serves to undermine the objections to a clawback action against the innocent Ponzi scheme winner. Instead, we might well want to object to clawback actions against both. *Cf. In re Estate of Wolf & Vine, Inc.*, 77 B.R. 754, 760 (C.D. Cal. 1987) (objecting to a clawback suit in the wake of an LBO against innocent former shareholders, on the ground that the share purchase "was an entirely fair transaction from the seller's perspective. In the Court's view, it is an unwarranted extension of the fraudulent conveyance laws, or any laws, to attempt to deprive [the former shareholders] of the value they received in exchange for their business."), *aff'd sub nom. Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988). Both cases, that is, might well involve an indefensible effort to recoup money in order to defray another's losses.

Part V.A and beginning to develop a proposal for how this might be done in Part V.B.

A. *The Winners Reasonably Believed in the Authenticity of Their Winnings*

While the innocent Ponzi scheme winners are no less entitled to the “profits” they withdrew than are its losers, nor are they more entitled to them. However, the same can be said of any investor who profits from an arms-length investment. The innocent winners in a Ponzi scheme are no less entitled to their earnings than the winners in a legitimate investment scheme are entitled to the money they earn on their investment. That is the central insight motivating the arguments set forth here.

Where some investors come out ahead and others come out behind, and luck is the only feature that separates the two, we might well want to counteract its effects. It is better to reclaim some money from the winners and transfer it to the losers, so that all share in the losses equitably. This is not to say that all cases in which fortune chooses the winner entail an obligation, or even a reason, for the winner to share her winnings among all of the game’s participants. For example, we would not think that the person holding a winning lottery ticket has any reason, let alone an obligation, to share the jackpot with all of the other lottery ticketholders.

One clear way to draw a line between the lottery case and the Ponzi scheme case is to look to the participants’ reasonable expectations. The lottery ticket-holders know that only one of them will win, that the others will have supplied the money the winner wins, and that luck alone will determine the winner. The Ponzi scheme investors, on the other hand, reasonably conceive of themselves as sitting in the same boat: All who invest at the same time would win or lose together, and whether they were to win or lose would turn, they believe, on the scheme operator’s investment savvy, not the point in time at which they were to choose to withdraw their funds, which cannot be said to enhance or diminish the putative investors’ level of desert, given their presumed ignorance of the fraudulent nature of the scheme.<sup>202</sup> At least in cases of financial

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<sup>202</sup> See *supra* notes 41-48 and accompanying text (presenting reasons to think the Madoff Ponzi scheme winners were blamelessly ignorant of his fraud). A real-life case bears out the claim that those Ponzi scheme winners who cashed out early are no

wrongdoing, where all investors are innocent yet some profit from the wrongdoing while others lose out, we might want to have those who have come out ahead to help defray the losses of those who would have otherwise come out behind.<sup>203</sup>

Two questions present themselves at this point. First, why should we conceive of the scope of restitution as specific to a particular fraud, such that there is a special restitutionary relationship between the winners and losers of that fraud, rather than a general relationship that operates between winners and losers in the market as a whole? Second, why think that only those who benefit from a fraud may be made to offer restitution, rather than thinking that anyone who wins in the market—whether through a fraudulent or legitimate investment vehicle—ought to contribute? I address these questions in turn.

Suppose that we were to decide that the “winners” in some financial frauds should have to give up their winnings and that the “losers” should receive compensation. Why require that restitution operate strictly between winners and losers of

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more or less deserving than those who had open accounts at the time of the scheme's collapse and lost money they had invested or at least profits they thought they had earned: Steve Simkin and Laura Blank divorced in 2006, and split the \$5.4 M in their Madoff account equally between them. Ms. Blank cashed out shortly thereafter, receiving 50% of the then-stated value of the money in their Madoff account. Mr. Simkin did not seek to withdraw most of his share of the money in the Madoff account and, when the scheme went bust, he lost the money he believed the account had held. He sought to sue Ms. Blank for a rescission of this part of their divorce agreement, arguing that, unbeknownst to them at the time, the Madoff account never existed, and so should not have been counted among the couple's joint assets. Mr. Simkin lost at the trial level, but won on appeal. New York's highest state court then reversed, on the ground that the Madoff account did exist—at least until December 2008, any time before which Mr. Simkin could have sought to cash out for the full amount he believed the account contained. *See, e.g.,* Peter Lattman, *Court Says Madoff Victim Can't Redo Terms of His Divorce*, N.Y. TIMES (DEALBOOK) (Apr. 3, 2012, 7:51 PM), <http://dealbook.nytimes.com/2012/04/03/court-says-madoff-victim-cant-redo-terms-of-his-divorce/>.

The Simkin-Blank dispute, then, presents us with a case in which a court effectively refuses to compel a particular winner to retribute a particular loser even though the court had no reason to think that the winner deserved her winnings any more than the loser deserved his losses.

Other cases in which one set of participants in a game or scheme fares far better than another solely as a matter of luck may be more complicated. (Consider, for example, the fortunes of the shareholders of a non-mining corporation at the time that it unexpectedly strikes gold relative to those of the prior shareholders who had cashed out before the gold strike.) I leave these more complicated cases to one side.

<sup>203</sup> The notion that the winners and losers sit in the same boat appears to have escaped the notice of some members of both parties, as they proceed on an “every man for himself,” basis, to use the words of one Madoff investor, and engage in a “reality-show kind of fighting.” Eric Konigsberg, *Investors in a Competition for a Piece of the Madoff Pie*, N.Y. TIMES, June 29, 2009, at B1, available at <http://www.nytimes.com/2009/06/29/29madoff.html> (quoting one of the Madoff claimants) (internal quotation marks omitted).

the same fraud? That is, why should the Madoff winners retribute the Madoff losers, rather than investors who were defrauded by Countrywide, for example? We now know that Countrywide overcharged customers who were desperately hanging onto their home loans—a federal offense for which it paid \$108 million in fines<sup>204</sup>—and discriminated against Black and Hispanic borrowers, for which it paid an additional \$335 million fine.<sup>205</sup> These fines presumably diminished the share value of those who held shares in Bank of America, which acquired Countrywide in 2008, at the time the fines were paid. Those who sold shares in Countrywide or Bank of America before the offenses were uncovered presumably received more money for their shares than they were worth, since Countrywide's offenses inflated the share value at the time of sale.<sup>206</sup> It might then be reasonable to think that the investors who innocently profited by selling Countrywide's fraudulently inflated shares owe some or all of the profits they earned to those who bought the shares at an artificially inflated price, or to those whose shares diminished in value as a result of Countrywide's fines. But again, why think that restitution should operate just between the Countrywide investors?

To take an example that hits even closer to the Madoff scandal, consider that shareholders in “J.P. Morgan Chase [collectively] earned after-tax profits totaling \$435 million between 1993 and 2008 as a result of the billions of dollars Madoff deposited in the bank using his investors' money.”<sup>207</sup> Yet no clawbacks are being pursued against these shareholders.

Why shouldn't the Madoff winners help defray the losses of the Countrywide losers, and why shouldn't the Countrywide or J.P. Morgan Chase winners help make the

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<sup>204</sup> Fed. Trade Comm'n, Press Release: Countrywide Will Pay \$108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy, June 7, 2010, available at <http://www.ftc.gov/opa/2010/06/countrywide.shtm>.

<sup>205</sup> See, e.g., Charlie Savage, *Countrywide Will Settle a Bias Suit*, N.Y. TIMES, Dec. 21, 2011, at B1, available at <http://www.nytimes.com/2011/12/22/business/us-settlement-reported-on-countrywide-lending.html>.

<sup>206</sup> See, e.g., Ben Protess, *Bank of America Profit Drops 37%*, N.Y. TIMES (DEALBOOK) (Apr. 15, 2011, 7:27 AM), <http://dealbook.nytimes.com/2011/04/15/bank-of-america-profit-drops-nearly-36/?smid=pl-sare> (“Bank of America reported a 37 percent drop in first-quarter earnings on Friday, as the nation's biggest bank continued to battle the legacy of the mortgage crisis and legal problems linked to the ill-fated acquisition of Countrywide Financial.”).

<sup>207</sup> Louis R. Davis & Linus Wilson, *Estimating JP Morgan Chase's Profits from the Madoff Deposits*, 14 RISK MGMT. & INS. REV. 1, 107-19 (2011).

Madoff losers whole?<sup>208</sup> The answer is surely related in part to administrative convenience; the trustee in the Madoff case does not have authority to claw back money from individuals who did not have accounts with Madoff. However, administrative convenience is relevant only if we have already determined that there *is* an obligation on the part of those who win in a fraudulent scheme of which they were ignorant to defray the losses of those who lose, whether from that same fraudulent scheme or from another. The innocent winners in a Ponzi scheme are not more responsible for the losers' losses than is anyone else who is innocent of the fraud. So, we must turn to the second question—why think that those who innocently profit from a fraud bear obligations of restitution that those who profit from a legitimate investment lack?

This question lacks a good answer. The innocent winners in a Ponzi scheme are innocent not just in the sense that they did not know—and had no reason to know—of the fraud, but also in the sense that, from their perspective, their withdrawals represented earnings as legitimate as the earnings they would have reaped from a genuine investment vehicle. It is on this ground that Judge Rakoff held that innocent investors in Madoff's scheme may avail themselves of the Bankruptcy Code's safe harbor provision,<sup>209</sup> which "precludes the Trustee from bringing any action to recover from any of Madoff's customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud."<sup>210</sup> Importantly, Judge Rakoff readily acknowledged that no securities were bought or sold, and that Madoff himself would not have been permitted to avail himself of the safe harbor provision.<sup>211</sup> Nonetheless, "[f]rom the standpoint of Madoff Securities' customers (except for any who were actual participants in the fraud), the settlement payments made to them by Madoff Securities were entirely bona fide, and they

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<sup>208</sup> Alan Strudler has intriguingly pursued questions of this kind in the context of large-scale accidents. Alan Strudler, *Mass Torts and Moral Principles*, 11 L. & PHIL. 297, 323-25 (1992). Strudler argues that even if one is merely causally responsible, and not morally responsible for accidental harm, one nonetheless bears an obligation to repair the harm that innocent bystanders lack. Whatever the merits of Strudler's account for cases of mere causal responsibility, it is inapposite where, as here, one cannot even say that the innocent beneficiaries of the fraud caused the injury that the losers sustained.

<sup>209</sup> *Picard v. Katz*, 462 B.R. 447, 451 (S.D.N.Y. 2011). The safe harbor provision is contained in 11 U.S.C. § 546(e) (2006).

<sup>210</sup> *Katz*, 462 B.R. at 451-52.

<sup>211</sup> See *Picard v. Katz*, 466 B.R. 208, 212 (S.D.N.Y. 2012).

therefore are fully entitled to invoke the protections of section 546(e) [i.e., the safe harbor provision].<sup>212</sup> Judge Rakoff also implied elsewhere that what matters is the investors' reasonable belief and, so long as that belief *is* reasonable, the court must treat the investors as if the belief were true,<sup>213</sup> at least for purposes of the avoidance actions.<sup>214</sup>

Judge Rakoff's position supports the idea that the innocent investors reasonably relied on the authenticity of their withdrawals. Where a Madoff winner spent the money she withdrew—whether on grandchildren's college tuition, living expenses, or even extravagant travel<sup>215</sup>—it might be unfair to pursue a clawback action against her, even if she is not so destitute as to be able to meet the trustee's hardship standard.<sup>216</sup> More to the point, since the latter set of investors has no more ground for relying on the legitimacy of their withdrawals than the winning Ponzi scheme investors have, it is unfair to treat Ponzi scheme winners differently from investors who withdraw money from a legitimate investment vehicle. As one commentator notes, "by what grace of God were many of us fortunate enough not to have relied on a

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<sup>212</sup> *Katz*, 462 B.R. at 452 n.3.

<sup>213</sup> *See, e.g., Picard v. Katz*, 466 B.R. 208, 211 (S.D.N.Y. 2012) ("[I]f Madoff Securities was *fairly viewed* by the defendants and other customers as engaged in the business of effecting transactions in securities . . . [then] the Trustee . . . may well be barred from [pursuing avoidance actions except in cases of actual fraud due] to the application of § 546(e)." (emphasis added)).

<sup>214</sup> Peter Henning has noted that Rakoff's position conflicts with the Second Circuit's net equity position, which declines to use as the basis of recovery the amounts investors *believed* they had in their Madoff accounts. *See Henning, supra* note 12. Still, Rakoff did not have before him the question of what investors were owed; he was addressing the different question of what they could, or could not, be made to return. It is possible that there is a principled basis upon which one could credit the investors' reasonable beliefs for purposes of the clawback suits but not for purposes of determining their net equity.

<sup>215</sup> *See, e.g., Madoff's Victims*, MADOFFSCANDAL.COM: THE LARGEST FRAUD THAT THE WORLD HAS EVER SEEN, <http://www.madoffscandal.com/madoffs-victims/> (last visited Mar. 12, 2012) (describing Ira Roth, whose withdrawals from his Madoff account were used to pay for his college tuition and his grandmother's living expenses); U.S. Attorney's Letter and Attached Victim Impact Statements (Mar. 13, 2009) *United States v. Madoff*, No. 09 Crim. 213 (DC) (S.D.N.Y. June 15, 2009), *available at* [http://www.cbsnews.com/htdocs/pdf/Madoff-Victim\\_Impact\\_Statements.pdf](http://www.cbsnews.com/htdocs/pdf/Madoff-Victim_Impact_Statements.pdf) (quoting from Letter from Ted and Sue Rehage to Senators Baucus, Grassley, and United States Senate Finance Committee members, which stated: "As a result [of our Madoff losses], our traveling will be curtailed with no more 9 or 10 weeks with the grandkids which is disappointing for all of us. Now it will be a week or two in state at best.").

<sup>216</sup> For Picard's list of the indicators he believes relevant to determining hardship, *see Hardship Program*, THE MADOFF RECOVERY INITIATIVE, <http://www.madoff.com/hardship-program-17.html> (last visited Mar. 12, 2012).

Madoff . . . or somebody like [him]?”<sup>217</sup> It may be no more than “dumb luck” that separates Ponzi scheme winners from those who win in a legitimate investment.<sup>218</sup> And why should luck play such a decisive role in how one fares?<sup>219</sup> In particular, why should we expect more from the innocent beneficiaries of a fraud than we expect from the innocent beneficiaries of a legitimate investment? The simple answer is that we should not.

If this correct, one of two implications follows—either we should permit losses to remain where they fall, or we should enlist the Ponzi scheme winners *along with all other investment winners* to provide restitution. If the foregoing comments about luck have any intuitive appeal, they militate strongly in favor of the latter alternative. To allow losses to remain where they fall is to allow luck to govern how the winning and losing investors fare. But we can do better than that; we need not bow to luck’s whims. A form of restitution that gathers resources from all investment winners provides a more appropriate solution.

### B. *Market-Wide Restitution*

A handful of commentators have championed the idea that winners and losers in a Ponzi scheme should together share in the losses the fraud has caused. Yet these commentators contemplate only intra-scheme restitution; they presume but do not defend the existence of a special connection binding the winners of a particular fraud to the losers of that fraud.<sup>220</sup> By contrast, Part V.A demonstrated that all of those

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<sup>217</sup> Jeffrey M. Lipshaw, *Disclosure and Judgment: “We Have Met Madoff and He Is Ours,”* 35 U. DAYTON L. REV. 139, 139 n.1 (2009).

<sup>218</sup> *Id.* at 139.

<sup>219</sup> Indeed, many Madoff winners maintain that they were actually less greedy than were other winning investors in the market, having forsaken higher returns for Madoff’s steady but comparatively modest returns. So, if one did want to invoke the notion of desert, the Madoff winners would, at least on this basis, fare better than the investors in legitimate but aggressive and higher-performing schemes. See, e.g., Jon Healy, *Are Bernard Madoff’s Victims Greedy?*, L.A. TIMES (Aug. 19, 2011, 2:58 PM), <http://opinion.latimes.com/opinionla/2011/08/are-bernard-madoffs-victims-greedy.html>. Cf. Complaint at \*2 ¶ 3, *Haines v. Mass. Mut. Life Ins.*, 2009 WL 958069 (D. Mass. 2009) (No. 1:09cv10182), available at <http://clients.oakbridgeins.com/clients/blog/haines.pdf> (seeking class action relief against Madoff feeder funds and alleging that “[p]laintiffs and the other investors in these funds were not wild speculators rolling the dice for high returns, but rather safe-conservative investors looking to protect and grow their retirement funds.”).

<sup>220</sup> See Cherry & Wong, *supra* note 15, at 408-10 (arguing for the desirability of *ex ante* clawbacks—i.e., provisions in the contract that a prospective investor signs that requires the investor to share in the losses should fraud emerge); Pozza et al., *supra* note 4, at 131 (“[A] fundamental principle should be that all victims share the

who innocently win in the market are similarly situated, whether their winnings arise from legitimate or fraudulent investment vehicles. All of them share responsibility for restituting fraud's victims. Implementing this insight need not involve a novel crafting of policy. Instead, one or both of two currently debated tax initiatives would do the trick, by effectively raising the money needed to sustain a fraud compensation fund.

The first is a variant on the financial transactions tax (FTT), also called a Tobin Tax.<sup>221</sup> While the idea for such a tax emerged in the 1970s and was originally conceived as a restraint on currency speculation, there has been a renewed vigor in calls for adoption of a more encompassing FTT after the 2008 financial meltdown.<sup>222</sup> In particular, as its supporters now envision it, the FTT would be assessed on most financial transactions and would affect most asset classes.<sup>223</sup> The recent enthusiasm for an FTT stems from two policy goals that supporters believe it will serve. First, it will curb “socially useless” short-term equity transactions,<sup>224</sup> and second, it will impose some of the costs of risky bank activity on the banks that contribute to systemic risk.<sup>225</sup> But there is an additional benefit, especially relevant here. An FTT would raise money that could be used to compensate the victims of fraud. In particular, investment winners would contribute money to the compensation fund in proportion to the amount of their winnings, and the FTT rate could vary depending on whether the seller stood to reap a net gain from the transaction. A base tax would apply in all cases and its revenues could serve both policy goals described above. An additional tax could be levied against investment gains, with the money raised financing a

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pain on an equal basis. Simply because someone has cashed out before discovery or received proceeds for years, which are traceable to other Ponzi victim investments, should not allow them to have less pain than those who have received back little or nothing from the Ponzi schemer.”)

<sup>221</sup> See, e.g., Edmund Conway, *Joseph Stiglitz Calls for Tobin Tax on All Financial Trading Transactions*, TELEGRAPH (Oct. 5, 2009), <http://www.telegraph.co.uk/finance/financialcrisis/6262242/Joseph-Stiglitz-calls-for-Tobin-tax-on-all-financial-trading-transactions.html>; Carsten Volkery, *Euro Zone Split over Financial Transaction Tax*, DER SPIEGEL (Mar. 13, 2012), <http://www.spiegel.de/international/europe/0,1518,820965,00.html>.

<sup>222</sup> See, e.g., Volkery, *supra* note 221. The G20 had debated, but failed to agree upon, an FTT at its September 2009 meeting.

<sup>223</sup> *Id.*

<sup>224</sup> See, e.g., Paul Krugman, *Taxing the Speculators*, N.Y. TIMES, Nov. 27, 2009, at A39.

<sup>225</sup> Thus, a bill was introduced in the House entitled, “H.R. 4191: Let Wall Street Pay for the Restoration of Main Street Act of 2009.” H.R. 4191, 111th Cong. § 1 (2009).



fraud victim compensation fund. In this way, the added tax would affirm the moral equivalence between the innocent winners and losers in financial transactions, as well as the moral equivalence between the innocent winners of a fraudulent scheme and the innocent winners of a legitimate one.

A second option, which could be implemented in addition to, or instead of, the varying rate FTT, would be to answer the calls to raise the capital gains tax<sup>226</sup> and to devote some of the revenue garnered from the tax increase to a fraud compensation fund. Here, too, the measure would recognize that, from the perspective of the innocent investor, it may be purely a matter of luck whether her investment dollars landed in a legitimate investment vehicle or a fraudulent one.

The money set aside for fraud compensation—whether funded through an FTT, an increase in the capital gains tax, or both—would operate as a second tier of relief, after money garnered from the fraudster and her associates had been exhausted. Thus, trustees would still be needed in the wake of a fraud in order to identify those with a culpable connection to the fraud, to pursue clawbacks and punitive damages against them, and to ferret out claimants who knew or should have known about the fraud. Yet since either scheme would remove the need to seek clawbacks from innocent investors, the fund's administration would be far more streamlined, and innocent winners would save a significant amount of money that they currently devote to defending themselves in clawback suits.

While the foregoing proposal paints in broad strokes and many of the details remain to be worked out, it does suggest that ready solutions exist for ensuring that victims of fraud receive redress. More to the point, the proposed initiatives would appropriately distribute the burdens of restitution to all of those who profit from their investments.

## CONCLUSION

Clawback suits against innocent beneficiaries of a fraud can be sustained neither by statute nor by other doctrines. Indeed, these suits are exceptional insofar as they demand that innocent individuals or entities return money they reasonably

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<sup>226</sup> See, e.g., Eliot Spitzer, *The "Romney Rule": Why Raising Capital Gains Taxes is Morally Right and Economically Wise*, SLATE (Feb. 6, 2012, 12:32 PM), [http://www.slate.com/articles/news\\_and\\_politics/the\\_best\\_policy/2012/02/the\\_romney\\_rule\\_raising\\_capital\\_gains\\_taxes\\_is\\_both\\_morally\\_right\\_and\\_good\\_for\\_the\\_economy\\_.html](http://www.slate.com/articles/news_and_politics/the_best_policy/2012/02/the_romney_rule_raising_capital_gains_taxes_is_both_morally_right_and_good_for_the_economy_.html).

believed was theirs in order to redress another's wrongdoing. Yet the innocent winners of a fraud are no more responsible for the losers' losses than anyone else. Although we should not require that the victims of fraud bear their losses alone, we need not require that restitution derive solely from those who also had the misfortune of choosing the same, fraudulent investment vehicle. The market is a place where fraud may well be ineradicable.<sup>227</sup> All those who subject their fates to its whims and who come out ahead as a result should share responsibility to redress the wreckage that fraud inflicts.

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<sup>227</sup> See, e.g., Elizabeth Warren, *Reforming a Corrupt Club*, WASH. POST, July 20, 2012, at A19, available at [http://www.washingtonpost.com/opinions/elizabeth-warren-libor-fraud-exposes-a-rotten-financial-system/2012/07/19/gJQAvDnDwW\\_story.html](http://www.washingtonpost.com/opinions/elizabeth-warren-libor-fraud-exposes-a-rotten-financial-system/2012/07/19/gJQAvDnDwW_story.html); Felix Salmon, *Why Finance Can't Be Fixed with Better Regulation*, REUTERS BLOG (July 23, 2012), available at 2012 WLNR 15675134.