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

Amy J. Sepinwall[*]

ABSTRACT

In a typical Ponzi scheme, early investors earn "profits" not through any legitimate investment activity on the part of the Ponzi scheme operator; instead the operator simply transfers money that later investors deposit to the earlier investors who seek redemptions. As such, when the scheme goes bust, as it must, the Ponzi scheme operator will not have enough money to cover all of the investors' deposits, let alone the earnings on those deposits that the investors thought they were owed. Should the scheme's winners – i.e., those who withdrew more money than they deposited – be compelled to return their fictitious profits to help defray the losses to the scheme's losers? Should they be required to do so even if they did not know, and had no reason to know, that theirs was not a legitimate investment?

Caselaw permits clawbacks from innocent winners in a Ponzi scheme, and there has been a dramatic rise in the number of such cases over the last decade. But, as courts have noted, the clawback suits rest upon two bodies of law – securities and bankruptcy -- that are on a "collision course." The two were never intended to interact and their interaction has produced confusion, unpredictability and unfairness. More troubling still, there has been no sustained inquiry into the foundational normative question – *viz.* whether innocent winning investors *should* be made to help defray the losses of the losing investors in the first place. This Article addresses that question, and it argues that clawback suits targeting blameless winners lack a compelling legal and equitable basis.

More specifically, the Article examines the relevant statutory framework as well as other restitutionary doctrines, and it finds that none of these can adequately justify attempts to have those who innocently profit from a fraud help restitute the fraud's victims. Nor, the Article argues, can the clawback suits be justified by appeal to basic concepts of fairness: It is true that mere luck differentiates the innocent winners of a fraud from its equally innocent losers, but it is also true that mere luck differentiates the innocent winners of a legitimate investment from the equally innocent winners of a fraud. All three sets of investors are in a morally equivalent position. It is unfair, then, to require only those who benefited innocently from a fraud to defray the losses to the fraud's victims. Instead, the Article concludes, all of those who benefit from playing the market – whether through legitimate or fraudulent investment vehicles -- should share responsibility for restituting the losses in which financial fraud results. The Article ends by proposing a mechanism for implementing the expansive restitutionary obligations that the Article seeks to defend.

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

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INTRODUCTION

We typically expect wrongdoers to redress the victims of their transgressions.[1] But do those who innocently benefit from a wrong 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.[2] Picard has filed over 1000 clawback suits,[3] seeking to recover from "winning investors" any money they garnered over and above that which they had invested, and to return this money to the Madoff "losers,"[4] – i.e., those who lost some or all of their principal when the Ponzi scheme went bust.[5] Ken Feinberg, former Special Master for the September 11 Victims Compensation fund,[6] therefore quips that the Madoff clawback suits have

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[1] *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." (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 the ill-gotten gains to the wrongdoers' victims, see Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500 (2011).

[2] *See infra* notes 113 and 114 and accompanying text. The S.E.C. defines a Ponzi scheme as "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors." S.E.C., *Ponzi Schemes – Frequently Asked Questions*, *at* http://www.sec.gov/answers/ponzi.htm (last visited Feb. 27, 2012).

[3] *See, e.g.*, Lisa Sandler & Bob Van Voris, *Madoff Trustee Defends 'Clawbacks' in U.S. District Court*, BLOOMBERG.COM, 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.

[4] I follow the bankruptcy trustee in referring to those who had withdrawn amounts equal to or greater than their principal as "winners," and to those who had not yet recovered all, or perhaps even any, of their principal at the time the scheme collapsed as "losers." Nonetheless, I note that is a tendentious way of describing the two categories of investor, 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 prejudge the equitable collection of funds and distribution to Ponzi victims.") (footnote omitted).

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

[6] *See, e.g.*, Margaret L. Shaw, *Madoff Victim Compensation: Interview with Ken Feinberg*, 16 No. 2 DISP. RESOL. MAG. 11, 11 (2010). He has also overseen compensation funds for victims of the Virginia Tech shootings, the BP oil spill, and Holocaust reparations. *See generally* http://www.feinbergrozen.com/.

Picard "taking from Peter to pay Paul."[7] 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.[8] The Madoff case thus provides us with an occasion to interrogate the grounds, and the bounds, of restitution as between the innocent beneficiaries and victims of a wrong.

We shall see that the question of whether, when and why the innocent winners in a financial fraud should be compelled to restitute the fraud's losers is both under-served by existing doctrine,[9] and under-

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[7] *See* Shaw, *supra* note 6.

[8] 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, Jul. 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*, NEW YORKER, May 30, 2011; 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 (last visited Aug. 9, 2011). 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. *Id. 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. 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, Jul. 28, 2011.

In the case against Wilpon and his associates, 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 (last visited Aug. 9, 2011). 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* at 15. 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.

[9] 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

studied by scholars.[10] Perhaps nowhere is the inattention more apparent, and potentially disquieting, than in the efforts to have innocent Ponzi scheme winners 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."[11] Neither of these bodies of law was designed with the other in mind,[12] and there is much that remains unsettled in determining the appropriate interaction between the two.[13]

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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, *When the Bezzle Bursts: Restitutionary Distribution of Assets After Ponzi Schemes Enter Bankruptcy*, 68 WASH. & LEE L. REV. 1589, 1598-99 (2011) (describing the general confusion around restitution, especially in the context of a bankruptcy).

[10] *Cf.* PETER BIRKS, UNJUST ENRICHMENT 3 (2005) ("Of the subjects which form the indispensable foundation of private law, unjust enrichment is the only one to have evaded the great rationalization achieved since the middle of the 19th Century in England and America by the writers of the textbooks.").

[11] Picard v. Katz, 11 Civ. 3605, S.D.N.Y., Sept. 27, 2011 at *4 (quoting In re Enron Creditors Recovery Corp., ___ F.3d ____, 2011 WL 2536101 (2d Cir. June 28, 2011) at *5 (quoting In re Resorts Int'l, Inc., 181 F.3d 505, 515 (3d Cir. 1999)). *See also Katz* at *2 (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 (2004) (discussing the untoward interaction of restitution and bankruptcy law).

[12] *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 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.").

[13] *See, e.g.*, Kathy Bazoian Phelps et al., *Fraudulent Transfer Claims and Defenses in Ponzi Schemes*, *in* FRAUDULENT CONVEYANCE CLAIMS: OFFENSE AND DEFENSE, 091009 ABI-CLE 209 ("[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-OCT AM. BANKR. INST. J. 48 (2010) ("Ponzi

More concerning, little thought has been given to whether the recovery provisions of bankruptcy law *ought* to extend to the innocent beneficiaries of a financial fraud. This is especially disquieting because there is no legal mechanism for recovering money from investors who innocently profited from a financial fraud committed by an entity *where the fraud does not result in the entity's bankruptcy*. In this way, Ponzi scheme winners incur harsher treatment than do those who innocently profit from other kinds of financial fraud, and there is no justification in the caselaw or commentary for this disparity in 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, those who innocently benefit from a transgression owe restitution to the transgression's victims. Providing such a theory is a central task of this Article, and it is hoped that the theory in question can usefully apply 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.

It is surprising that scholars have largely overlooked these clawback suits, given the troubling uncertainty and evident tensions they involve,[14] and the dramatic rise in their use: While the first set of clawback cases eventuating from a Ponzi scheme arose in the 1920s,[15] in

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schemes--one of the horrible byproducts unearthed by the financial crisis--have raised noteworthy and contentious bankruptcy issues."). *Cf.* 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."); Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28-APR AM. BANKR. INST. J. 16, 80 (2009) ("pursuing investors who lacked diligence in Madoff will unnecessarily cost hundreds of millions.").

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 (2010).

[14] *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 and 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).

[15] 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 v. Brown, 265 U.S. 1 (1924).

the wake of Charles Ponzi's now infamous fraud,[16] it was only in the 1980s that the use of a clawback suit to recover money from an *innocent* investor became widespread, and 149 of the 190 published state and federal cases were decided in or after the year 2000.[17] Further, commentators predict that these suits will become even more common in the coming years.[18]

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;[19] Madoff's proclaimed split-strike strategy;[20] and the SEC's failures to detect the fraud.[21] Other work has addressed alternative enforcement regimes in the case of a fraud like Madoff's;[22] or it has called for revisiting white-collar crime sentencing policy,[23] given Madoff's 150-year prison sentence[24] – likely the longest sentence ever imposed for a white-collar offense.[25]

The handful of scholars who have addressed the use of clawback suits against innocent investors in Ponzi scheme cases have largely

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[16] Cunningham v. Brown, 265 U.S. 1, 7-9 (1924) (discussing the collapse of Charles Ponzi's fraudulent investment program).

[17] *See infra* notes 86 and 87 and accompanying text (describing the evolution of the law on this score).

[18] *See, e.g.*, Michael C. Macchiarola, *In the Shadow of the Omnipresent Claw: A Response to Cherry and Wong,* MINN. L. REV. HEADNOTES (2011), *at* http://www.minnesotalawreview.org/headnotes/in-the-shadow-of-the-omnipresent-claw-in-response-to-professors-cherry-wong-2/#_ftn9 (last visited Feb. 24, 2012) ("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.").

[19] *See, e.g.*, Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. LAW REV. 947 (2009); Paul Krugman, *Madoff Explains Everything*, N.Y. TIMES, Nov. 17, 2011 ("The Madoff affair, as you may know, was a classic case of 'affinity fraud'").

[20] *See, e.g.*, Carole Bernard & Phelim P. Boyle, *Mr. Madoff's Amazing Returns: An Analysis of the Split-Strike Conversion Strategy*, 17 J. DERIV. 62 (2009)

[21] *See, e.g.*, Donald Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICH. ST. L. REV. 899-914.

[22] *See, e.g.*, Amanda M. Rose, *The Multi-Enforcer Approach To Securities Fraud Deterrence: A Critical Analysis*, 158 U. PENN. L. REV. 2173 (2010); Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463 (2010).

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

[24] Transcript of Sentencing Hearing at 43, United States v. Madoff, 626 F. Supp. 2d. 420 (S.D.N.Y. June 17, 2009) (No. 09 Crim. 213 (DC)).

[25] 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/.

agreed that the suits are, in principle, permissible, and possibly even worthwhile.[26] The only critical commentary that exists tends to take issue with the ways the suits are wielded in practice. Thus scholars have objected to judicial interpretations of the doctrine;[27] the ad hoc development of the law, which threatens uniformity and predictability;[28] the opportunity for abuse of discretion that the suits allegedly afford;[29] or the negative consequences to which the suits are believed to conduce.[30] There has been no sustained inquiry into the foundational normative question – *viz.* whether innocent winning investors *should* be made to help defray the losses of the losing investors in the first place. This Article addresses that question, and concludes that clawback suits targeting blameless winners lack a compelling legal and equitable basis.

More specifically, I examine attempts to extend the recovery provisions of bankruptcy law to the innocent beneficiaries of a Ponzi

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[26] *See, e.g.*, Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368 (2009).

[27] The most common line of criticism on this score takes issue with what is taken to be an overly demanding standard of good faith, failure to meet which entitles the trustee to reclaim not just money withdrawn as "profits" but withdrawn principal as well. *See, e.g.*, Sullivan, *supra* note 9 at 1615-23.

[28] *See, e.g.*, Pozza, Cox & Morad, *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 18, *Conclusion* (text accompanying notes 67-68).

[29] 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's complaint that the lawsuit against him and his associates is nothing more than "'an outrageous strong-arm effort to try to force a settlement by threatening to ruin our reputations and businesses.'").

[30] Thus, for example, Karen Nelson argues that the clawback suits create in-fighting 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, 1458 (2011). Nelson also argues that clawing back money from innocent investors "strays from America's fundamental tenets of capitalism." *Id.* 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 not culpably caused, or not 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 and luck should not play so great a role in determining whether or not 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 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 id.*

scheme and, through 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 more like investors who innocently profit from corporate or financial wrongdoing. Yet there is no area of law outside of the bankruptcy context in which innocent investors are made to return profits they earned as a result of the wrongful conduct of the corporations or brokerage firms in which they invested. If we do not seek to claw back profits from these innocent investors then we should not seek to claw back profits from the innocent Ponzi scheme winners either, I contend. That contention, of course, could cut in two diametrically opposed ways – in light of it, one could argue that we should allow the losses to lie where they fell, or else we should implement restitution on a far wider scale than the law currently allows. I end by seeking to defend the latter alternative, and suggesting measures through which it could be implemented.

The Article proceeds first, 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 provsions, and argue that there is only a weak doctrinal basis for the bankruptcy trustee's clawback efforts.[31] There is nonetheless considerable intuitive support for the notion that Ponzi scheme winners should return some of their gains to the scheme's losers – support that derives from our widely embraced rules around unjust enrichment and stolen goods: Where an individual gains as a result, and at the expense, of a wrong perpetrated against another, the individual may be compelled to return these "ill-gotten" gains. Similarly, where an individual purchases an item that unbeknownst to her is stolen, she must return the stolen item to its original owner, even if that means the innocent purchaser will be out the money she had paid to the seller. 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. In Part IV, I examine other doctrines that appear to impose pecuniary penalties on investors who innocently profit from corporate or financial wrongdoing, and I argue that the appearance is deceiving. These doctrines either extend only to investors who are not wholly innocent of the wrongdoing or else they 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

[31] *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 [the] 'clawback' lawsuits").

support for the Ponzi scheme clawback actions in the bankruptcy code, or within other equitable or legal doctrines. Is there, then, anything to be said on their behalf? In Part V, I contend that all those who profit in the market – whether from a legitimate or fraudulent investment vehicle – should help defray the losses that fraudulent schemes produce. I thus end by urging a far more expansive restitutionary program than that afforded by the clawback suits currently in place.

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 the clawback suits – and the murky, ad hoc, and oftentimes flawed judicial reasoning that these suits invite, or so I seek to argue here. 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 believe they were owed on the basis of their November 30, 2008, statements.

A. *History and Revelation of a Fraud*

Madoff created Bernard L. Madoff Investment Securities (BLMIS) in the early 1960s.[32] Originally, it functioned as a market maker and broker-dealer.[33] Later on, Madoff added an investment advisory arm to the business, and it was through this arm that Madoff recruited investors for his eventual Ponzi scheme.[34] At the time that he confessed, Madoff reported that the Ponzi scheme began in the early 1990s.[35] One of his associates has since revealed that the scheme in fact dates back to the early 1970s.[36] It is not clear how much of Madoff's business was fraudulent in the period between the 1970s and 1990s. What is known is that, beginning in the 1990s, Madoff did not buy or sell a single share on behalf of his customers even while he sent investors regular statements

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[32] *See, e.g.*, Complaint, SEC v. Madoff, 08-CV-10791, S.D.N.Y., Dec. 11, 2008, at *4, *available at* http://www.sec.gov/litigation/complaints/2008/comp-madoff121108.pdf.
[33] *See, e.g.*, *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.
[34] See, e.g., Plea Allocution of Bernard L. Madoff, *2, *available at* http://online.wsj.com/public/resources/documents/20090315madoffall.pdf.
[35] *Id.* at *2.
[36] *See, e.g.*, Associated Press, *Madoff Associate Says Fraud Went Back to '70s*, N.Y. TIMES, Nov. 21, 2011, at B4.

reporting market transactions and indicating an average growth of 12%,[37] claiming that his consistent positive returns resulted from a unique split-strike conversion strategy that he had pioneered.[38]

Because there were no investments, customer redemptions were funded with money other customers had deposited with Madoff. 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 using money that other customers had "invested" with him.[39]

Importantly, many of those who withdrew more money from their Madoff accounts were genuinely in the dark about his fraud. For one thing, Madoff, we now know, was masterful when it came to hiding his fraud. He maintained an aloof posture, often refusing a prospective investor before "accepting" her business;[40] his returns were consistent but also relatively modest so as not to arouse suspicion;[41] and the purported split-strike conversion strategy was a seemingly plausible vehicle for generating these steady, yet not spectacular, returns.[42] Further, a securities investor has no duty to inquire about his

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[37] *See, e.g.*, Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 101, 105 (2009).

[38] "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 BLMIS, 10-2378-bk(L), 2d Cir., Aug. 16, 2011, at *6.

[39] *See, e.g.*, Plea Allocution of Bernard L. Madoff, *supra* note 34 at *1.

[40] *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. SAMA, HISTORY OF GREED: FINANCIAL FRAUD FROM TULIP MANIA TO BERNIE MADOFF, Ch. 21 (2010).

[41] *See, e.g.*, Sullivan, *supra* note 9 at 1622-23.

[42] *See Assessing the Madoff Ponzi Scheme and Regulatory Failure: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 6 (2009) (testimony of Harry Markopolos, Chartered Financial Analyst, Certified Fraud Examiner) [hereinafter *Hearings*], *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/markopolos020409.pdf. *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 (last visited Aug. 9, 2011) ("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).").

stockbroker, even if confronted with suspicious circumstances.[43] (Willfully blinding himself to red flags, on the other hand, will undercut the investor's insistence that he proceeded in good faith.)[44] In any event, many of Madoff's investors knew that the SEC had investigated him, and never uncovered any financial wrongdoing;[45] they may well have relied – reasonably – on the fact that financial regulators believed Madoff's business to be clean.[46] With the benefit of hindsight, the SEC's efforts on this front leave much to be desired.[47] (As John Galbraith noted, "One of the uses of depression is the exposure of what auditors fail to find.").[48] Nonetheless, if the SEC proved 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.[49] Many investors, that is, profited from the fraud but did so innocently – they did not know, and had no reason to know, that Madoff was operating a Ponzi scheme.[50]

In the fall of 2008, with markets crashing, an unexpected number of Madoff customers sought to liquidate their accounts. Madoff could not possibly satisfy all of the claims; the scheme had gone bust.[51] Madoff confessed to his family on December 10, 2008. His sons, after consulting with their lawyer, tipped the police off to the fraud, and Madoff was

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[43] *See, e.g.*, Picard v. Katz, 11 Civ. 3605 (S.D.N.Y., Sept. 27, 2011) at *14-15 (citing In re New Times Sec. Servs., 371 F.3d 68, 87 (2d Cir. 2004)).
[44] *See id.* at *14.
[45] See, e.g., Zachary A. Goldfarb, *SEC Investigator Raised Madoff Suspicions in 2004 to No Avail*, L.A. TIMES, July 2, 2009, paragraph 9, *available at* http://articles.latimes.com/2009/jul/02/business/fi-sec-madoff2
[46] *See, e.g.*, Herve Stolowy et al., Information, Trust and the Limits of "Intelligent Accountability" in Investment Decision Making, Insights from the Madoff Case, SSRN, Sept. 27, 2011, at *15-17, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1930128 (collecting quotes from Madoff investors who stated that they were reassured that the investment scheme was legitimate as a result of the SEC's failure to uncover any fraud).
[47] *See* U.S. SECURITIES AND EXCHANGE COMMISSION OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME – PUBLIC VERSION, Report No. OIG-509, Aug. 31, 2009, *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf. This is a 457-page report detailing the SEC's missteps leading to its failure to detect Madoff's fraud despite multiple warnings and investigations.
[48] JOHN K. GALBRAITH, THE GREAT CRASH 135 (2009). Galbraith continues by quoting Walter Bagehot: "'Every great crisis reveals the excessive speculations of many houses which no one before suspected.'" *Id*.
[49] *See generally* Felicia Smith, *Madoff Ponzi Scheme Exposes "the Myth of the Sophisticated Investor*,*"* 40 U. BALT. L. REV. 215 (2010) (arguing 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").
[50] *See, e.g.*,
[51] *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.").

arrested the next day.[52] At the time, Madoff had 4800 customers with open accounts, who had a total of $20 billion invested with him, and the aggregate sum of the (fictitious) amounts appearing on their last statements, of November 30, 2008, was $65 billion.[53] 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.[54] The company officially went into bankruptcy on the day of Madoff's arrest.[55]

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.[56] SIPA instructs the trustee, *inter alia*, to "to distribute customer property and … otherwise satisfy net equity claims,"[57] and "to liquidate the business of the debtor"[58]; for the latter, the trustee is to proceed in accordance with the provisions of the bankruptcy code governing a bankruptcy under Title 11.[59]

In structuring his recovery efforts, the trustee has had to address two broad questions: first, who is entitled to restitution? And, second, from whom may funds be raised in order to 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. It will nonetheless be useful to examine the trustee's response to the first question, since it both demonstrates the legal uncertainty in this area, and sets the stage for the clawback suits.

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[52] *See, e.g.*, Ellen S. Podgor, *Madoff*, WHITE COLLAR CRIME PROF BLOG (Dec. 16, 2008) (last visited Mar. 6, 2012), http://lawprofessors.typepad.com/whitecollarcrime_blog/2008/12/the-madoff-case.html (listing a variety of media reports on the Madoff ponzi scheme); *The Madoff Case: A Timeline*, THE WALL STREET JOURNAL, March 12, 2009, paragraph 1, *available at* http://online.wsj.com/article/SB112966954231272304.html?mod=googlenews_wsj

[53] *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.

[54] *See, e.g.*, Lisa Sandler, *Madoff Brokerage, Homes, Boats Valued at $1 Billion (Update2)*, BLOOMBERG (January 9, 2009, 11:43 AM) http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZP0jyjuTdTI.

[55] *See* Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities, LLC., Adv. Pro. No. 08-01789 (S.D.N.Y. Bankr. Dec. 11, 2008).

[56] *See, e.g.*, *A Message from SIPA Trustee, Irving H. Picard*, THE MADOFF RECOVERY INITIATIVE, http://www.madoff.com (last visited Mar. 6, 2012). This is the 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 the home 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')."

[57] Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff(a)(1)(B), as amended through July 22, 2010.

[58] 15 U.S.C. § 78fff(a)(4).

[59] 15 U.S.C. § 78fff-4(e).

B. ***Defining "Customer" for Purposes of Determining Who May Recover from the Fraud***

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…."[60]

Among the first questions for the trustee to resolve, then, was who was to count as a customer entitled to "customer property," and what net equity these customers were due. Delineating the set of customers was complicated by the fact that, while some of those who lost money as a result of Madoff's fraud and who wanted to press claims of relief had invested directly with Madoff, others had invested in Madoff "feeder funds." Sixteen 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, holding that they did not count as "customers" under the SIPA statute.[61] The feeder funds appealed, and Judge Lifland's decision was affirmed by the Federal District Court for the Southern District of New York in an opinion issued in January of this year.[62]

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."[63] Investors in Madoff's scheme asserted claims in the amounts listed on the last statements they had received before the fund's collapse; [64] on the other hand, 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.[65] The former is referred to as the "last

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[60] 15 U.S.C. § 78fff.

[61] Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 454 B.R. 285 (Bankr. S.D.N.Y. 2011).

[62] Azora Bank Ltd. v. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, Case 1:11-cv-05683-DLC, S.D.N.Y., Jan. 4, 2012.

[63] Paul Sinclair & Brendan McPherson, *Does SIPC Protect Customers in Ponzi Scheme Cases? Sad Tale of Multiple Overlapping Fraudulent Transfers IV*, 29-4 AM. BANKR. INST. J. 18, 18 (2010).

[64] *See, e.g.*, In re BLMIS, 10-2378-bk(L), 2d Cir., Aug. 16, 2011, at *11; Peter Hennings, *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/ (last visited Mar. 6, 2012).

[65] *See* In re BLMIS, 10-2378-bk(L), 2d Cir., Aug. 16, 2011, at *10-11; Henning, *supra* note 12. 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, *Investor Beware: Many Holes Weaken Safety Net for Victims of Failed Brokerages*, N.Y. TIMES, Sept. 25,

statement" method of calculating net equity; the latter is referred to as the "net investment" or "cash-in-cash-out" method.

In a March 1, 2010, opinion, Judge Lifland adopted the "net investment" method: Customers would be entitled to recover only their principal, minus any withdrawals they had made over the life of their investments.[66] The Second Circuit affirmed this decision in an opinion issued on August 16, 2011.[67]

The Second Circuit adduced three grounds in support of its decision, none convincing on its own or in combination with the others. Specifically, it argued that allowing the net winners to recover any of the money they believed they had in their accounts would (1) place the trustee in the impossible position of having to invent recovery entitlements because Madoff's records were completely fictitious and so 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 making good on the fiction he had perpetrated. I address each of these in turn.

1. *Unascertainable Holdings*

The court's first set of arguments appeals 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*.'"[68] 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.[69] In response, it is worth noting that the plain text of the SIPA statute does not restrict net equity calculations to those ascertainable

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2000. 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.* Sinclar & McPherson, *Part IV*, *supra* note 63 at 1-2 (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").

[66] In re Bernard L. Madoff Investment Securities, SIPA Liquidation No. 08-01789 (BRL) (United States Bankruptcy Court, SDNY, Mar. 1, 2010, *available at* http://www.madoff-help.com/wp-content/uploads/2010/03/174497_1999_opinion.pdf.

[67] In re Bernard L. Madoff Investment Securities, Docket No. 10-2378-bk(L), (2d Cir., Aug. 16, 2011), *available at* http://www.ca2.uscourts.gov/decisions/isysquery/b500e183-23da-486c-8445-bd03b84e312b/1/doc/10-2378_opn.pdf.

[68] In re Bernard L. Madoff Investment Securities, Docket No. 10-2378-bk(L), (2d Cir., Aug. 16, 2011) at *21 (citing 15 U.S.C. § 78fff-2b (emphasis and alteration present in opinion)).

[69] *Id.* at *23.

from the debtors' books and records but instead explicitly allows alternative methods if these are "to the satisfaction of the trustee."[70] And, elsewhere, the court acknowledged the considerable discretion a SIPA trustee possesses in determining net equity,[71] and it therefore refused to endorse the cash-in-cash-out method as the strategy to be pursued in each and every case.[72] Thus it is possible that an alternative to both the last statement and net investment method exists; that it is preferable as a matter of fairness to either of these two; and that the trustee would be acting within his authority were he to pursue it.[73] 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."[74]

With that said, an alternative that defined net equity in a way that enlarged the set of investors entitled to recovery would entail, all else being equal, a smaller recovery for each, since the pool of accumulated funds would be divided among a greater number of claimants. This would mean that those 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 the scheme. This appears to be the concern animating the court's second and third lines of argument, as we shall now see.

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[70] 15 U.S.C. 78fff-2(b)(2).

[71] "[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.'" *Id.* at *24 n. 8. *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.") (internal 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.").

[72] "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 Investment Securities, Docket No. 10-2378-bk(L), at *24-25.

[73] 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.

[74] In re Bernard L. Madoff Investment Securities, Docket No. 10-2378-bk(L) at *24 n. 8.

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: "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."[75]

It is certainly true that taking principal plus some *post hoc* assignment of profits as the basis of recovery, rather than principal alone, would entail a greater outstanding sum needing compensation, such that each losing investor would receive less than on the Net Investment Method. But this is an "inequitable consequence" only if we have reason to privilege lost principal over lost (purported) earnings. Had the money been invested legitimately, customers would have been taken to be owed the amounts on their last statements, even if they had already recovered the amounts of their deposits and even if seeking to pay them their profits would, because of the estate's insolvency, entail that other 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 may 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. The question then arises: Why does the fictitious nature of the investments render this disparity unfair when it isn't unfair in the case of genuine investments?

The court, in its third argument, offers what might appear to be a response.

3. *Legitimating Fraud*

In endorsing the trustee's interpretation of net equity, the court stated that the "trustee properly declined to calculate 'net equity' by reference to impossible transactions. Indeed, if the Trustee had done otherwise, the whim of the defrauder would have controlled the process that is supposed to unwind the fraud."[76] Part of the court's concern arose from the fact that the "profits" Madoff recorded "were arbitrarily and

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[75] *Id.* at 23-24. *See also id.* at *17 (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." *In re Bernard L. Madoff*, 424 B.R. at 141.

[76] In re Bernard L. Madoff Investment Securities, Docket No. 10-2378-bk(L) at *33.

unequally distributed among customers."[77] (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 was correct to agree 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.'"[78] 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 for projecting what the investors would have been owed had Madoff invested their money in a legitimate vehicle, and in this way he needn't have relied on, let alone credited, the disparate ways in which Madoff treated his investors.

Further, there is no basis for the thought that providing investors with a recovery amount that comprehends interest on their deposits involves a kind of complicity in or affirmation of the fraud, contrary to what both the bankruptcy court and Second Circuit suggested.[79] Indeed, one might well 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 Ponzi scheme operator *intends* to defraud or otherwise hinder his investors' ability to recover their investment.[80] A recovery program more expansive than Picard's would then thwart, and not 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 any more justifiable, as a matter of law or fairness. And the latter has fairness implications that extend well beyond the denial of the winners' claims to any recovery, as we shall now see.

C. *Setting the Stage for the Clawback Actions*

The net equity decision had several implications relevant to the clawback actions. First, the 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

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[77] *Id.* at *23.
[78] *Id.* at *24 (quoting 424 B.R. at 140).
[79] *See* 424 B.R. at 136 (stating that the Net Investment method allowed Picard to "unwind[], rather than legitimz[e], the fraudulent scheme"); In re Bernard L. Madoff Investment Securities, Docket No. 10-2378-bk(L) at *33.
[80] *See infra* note 90 and accompanying text (describing the Ponzi scheme presumption).

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 were that money not to be returned to them.

Second, the decision entailed that only the Madoff "losers" would count as "customers" for purposes of recovering net equity; net "winners" would join the ranks of other creditors of the estate – they would recover the fictitious amounts they thought they were owed only if, and only after, the "losers" were made whole.[81] To see this more concretely, imagine, for example, an investor, Smith, who had deposited $1M in 1980. Smith's last statement reported $8M worth of securities. Even though Smith reasonably relied upon the veracity of his statement, he would not be entitled to recover any more than $1 million under the interpretation of net equity adopted by the Bankruptcy Court.

Third, it 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 of the money they had withdrawn in excess of that which they had invested. Thus, to return to the preceding example, if, say, in 2004, Smith had withdrawn $2 million, he could also be subject to a clawback action for the $1 million he had withdrawn in excess of the $1 million he had invested.

Finally, matters would be still worse for Smith if the bankruptcy trustee could establish that Smith evidenced a lack of good faith at the time that he received the $2 million, in light of a provision in the bankruptcy code described below that allows the trustee to void a transfer if, at the time of the transfer, the transferee knew or had reason to know of the fraud. In that event, the trustee could seek return not just of the $1 million in "profits" that Smith had withdrawn; the $1 million that reflected Smith's principal could also be subject to being clawed back. 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 avoided, leaving Smith with a net loss of one million real dollars.[82]

With all of that said, it is imperative to note that 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

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[81] *See, e.g.*, *What Is the Difference Between the Customer Fund and the General Estate?*, THE MADOFF RECOVERY INITIATIVE, http://www.madoff.com/facts-08.html.

[82] In Picard v. HSBC, 11-Civ.-763, S.D.N.Y., Jul. 28, 2011, 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," *HSBC*, at 22-24. That doctrine prevents one wrongdoer from suing one of her fellow wrongdoers for damages arising from their shared wrongdoing. 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, Jul. 29, 2011, *at* http://dealbook.nytimes.com/2011/07/29/madoff-trustees-job-just-became-much-tougher/ (last visited Feb. 24, 2012).

with outstanding account balances were not eligible to recover more money than they had deposited *and* that those investors who had already withdrawn more than they had deposited would nonetheless get to keep the withdrawn "profits." In other words, 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 "winnings" they had received before the bankruptcy. Thus, for example, 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.[83]

Nonetheless, as of December 10, 2010, Picard had filed complaints against over 1000 investors seeking return of their "fictitious profits," and in some cases their withdrawn principle,[84] for a total recovery of more than $100B, if successful.[85] 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.[86] Yet it was only in the mid-1980s that bankruptcy trustees in Ponzi scheme cases began pursuing clawback actions against innocent investors in the scheme who withdrew more than they had invested.[87]

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[83] 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*, see text accompanying note 85, Picard ended up filing clawback suits seeking a total of more than $100 billion, even though the outstanding principle didn't amount to more than $20 billion. 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, Picard v. JPMorgan Chase & Co., 11-cv-913 (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.

[84] *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/.

[85] *See, e.g.*, *id.*

[86] *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).

[87] 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, 281 F. 973 (1st Cir. 1922), the trustee lost since the law in question required the trustee to establish that the

The clawback suits rely upon a provision of the bankruptcy code, from which the SIPA borrows,[88] allowing a SIPA trustee to void (or, to use the technical term, "avoid") any transfer from the debtor's estate that was conveyed fraudulently.[89] More specifically, 11 U.S.C. § 548 provides, inter alia, 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 or undercapitalized or overextended at the time of the transfer or he became so as a result of the transfer]." The (A) prong of the provision pertains to cases of actual fraud,[90] and the (B) prong to cases of constructive fraud.[91]

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defendant – *i.e.*, the target of the clawback suit – had actual knowledge of the fraud, and this the trustee had failed to do. 281 F. at 976. The trustee lost a second case arising from Ponzi's fraud on similar grounds. *See* Cunningham v. Merchants' Nat. 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., 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 102-104 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. Conroy v. Shott, 363 F.2d 90 (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 (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.

[88] *See* 15 U.S.C. § 78fff-4(e).

[89] 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 (1998); Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221 (2009).

[90] 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, 396 B.R. at 843). *See, e.g.*, *Manhattan Inv. Fund Ltd.,* 397 B.R. 1, 8 (S.D.N.Y.2007) ("There is a general rule-known as the

On its face, the text of this provision allows for two different interpretations regarding the provision's rationale. On the first, the purpose of the fraudulent transfer provision is to prevent the debtor from secreting away his assets, typically for his own benefit, so that they are beyond the reach of his creditors. We may refer to this as the *anti-fraud reading (AF)* of Section 548. In contrast, on the *even distribution (ED) reading*, the purpose of the fraudulent transfer provision is to ensure that the distribution of assets among creditors is as even as possible, by conferring upon each creditor his pro-rata share of the recovered resources.[92] Put differently, AF attends to the value of estate, while ED

'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.' "); SEC v. Res. Dev. Int'l, LLC, 487 F.3d 295, 301 (5th Cir. 2007) ("In this circuit, proving that IERC operated as a Ponzi scheme establishes the fraudulent intent behind the transfers it made."). *See generally* McDermott, *supra* note 89 at 173-74 & n. 66 (collecting cases). Nonetheless, a lawyer representing a defendant in a clawback suit might well 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 to the operator's intentions relative to the transfers that are the subject of the clawback suit. It may well 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.

[91] 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 89 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 (C.A.7 (Ill.), 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 in any event. *See infra* Part III.B.

[92] Robert Clark uses the term "evenhandedness" to refer to one of the objectives of the avoidance provisions in bankruptcy law. Robert C. Clark, *The Duties of the Corporate*

attends to its distribution among creditors.

I shall now argue that Picard's clawback actions find support only in the ED reading of Section 548, but that the history and text of Section 548 strongly favor the AF reading.

To see that the letter of the law is compatible with the ED reading and so would, on that basis, support the clawback actions, consider, for example, the (B) prong of Section 548, which is intended to cover instances of constructive fraud. Again, that prong 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 or undercapitalized or overextended at the time of the transfer or he became so as a result of the transfer. It is reasonable to assume that any "profits" a Madoff customer withdrew were profits for which the fund received less than a "reasonably equivalent value"– after all, this was money over and above the amount the customer had invested. Further, because 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" look to satisfy Section 548's criteria for a constructively fraudulent transfer, and so look to be subject to avoidance.

With that said, it is important to note that the clawback actions nonetheless deviate from the spirit of the fraudulent transfer provision, or so I shall now argue. More specifically, if we look at the history of the fraudulent transfer provision, as well as other elements of the statutory scheme, we shall see that the fraudulent transfer provision was not intended to be used to recoup money from transferees like the Madoff "winners."

The bankruptcy code's fraudulent transfer provision has its genesis in a 1570 Statute of Elizabeth,[93] which is virtually identical in its language to the first part of the current fraudulent transfer provision. That 1570 law provided that "Creditors may avoid conveyances made by debtors with the end, purpose and intent to delay, hinder or defraud creditors."[94] (Compare 11 U.S.C. § 548: "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….").

The basic idea behind the Statute of Elizabeth was to counteract the

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Debtor to Its Creditors, 90 HARV. L. REV. 505, 511-512 (1977). As he explains, "the ideal of Evenhandedness toward creditors … connot[es] … equality of treatment of legal obligations in connection with liquidation proceedings." *Id.*

[93] Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 829 -830 (1985).

[94] 13 Eliz. Ch. 5 (1570).

following kind of mischief: At the time, there were certain sanctuaries into which the king's writ could not enter. Debtors would take refuge in these sanctuaries but, before doing so, would sell their assets to their friends and family members for a nominal sum, so that creditors could not reach them. Then, when their creditors finally gave up, or the statute of limitations had expired, the debtor would buy back the assets from his friends and family and, presumably, live happily ever after.[95] To prevent this practice, the statute of Elizabeth was passed: If the debtor sold, say, his flock of sheep for a pittance, creditors could avoid the transfer -- they could undo it -- for the sake of returning the sheep to the estate so that creditors could access its value.[96]

So, the untoward act that the Statute of Elizabeth contemplated was not one where the debtor gives money to 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 those assets once the debtor was beyond his creditors' reach. In other words, the Statute of Elizabeth did not seek an even distribution among all creditors; it merely sought to prevent situations in which the debtor attempted to safeguard his 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. Take, for example, the provision permitting avoidance of a transfer just so long as it is made with fraudulent intent.[97] If the objective of the fraudulent transfer provision were to ensure an even distribution among creditors, it would make no sense to allow for avoidance only in the event that the debtor transferred assets with an actual or constructive fraudulent intent. To see this, consider the following hypothetical: Suppose that, the year before he became insolvent,[98] our Elizabethan deadbeat gave his flock of sheep to his doctor, in exchange for medical services rendered, with no expectation of having the sheep returned. There would be no fraud here, and yet the estate would be just as badly off as if the debtor had 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. That we allow the doctor to keep the sheep – simply because they were not conveyed with a fraudulent intent – suggests that we are not concerned to ensure an

[95] Baird & Jackson, *supra* note 93 at 830.
[96] The example is Baird and Douglas's. *See id.*
[97] 11 U.S.C. § 548(a).
[98] 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.

even distribution.[99]

A second piece of evidence supporting the Anti-Fraud reading of Section 548 over the Even Distribution reading emerges from a provision in the bankruptcy code allowing 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." 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% of the money he has withdrawn. If the Ponzi scheme operator is completely insolvent at the time that the scheme collapses, Jones will end up with nothing. Again, if the purpose of Section 548 were to ensure an even distribution between creditors -- in this case, between Smith and Jones -- the fact that Smith had taken in good faith would be of no moment. Smith would instead be required to give back 50% of the money he had withdrawn, in order to offset Jones' losses. But that's not the way the law works. Smith gets to keep the full amount of his withdrawal, and Jones gets nothing.[100]

Moreover, the distinction between "*net* winners" and "*net* losers" lends further support to the AF reading. Where an investor has received

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[99] 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 the transaction in which they engaged with the fraudster legitimate. So, again, the question of the grounds for the disparity in treatment arises.

[100] 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., LLC, 439 B.R. 284, 310-312 (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 at1618 (footnotes omitted).

no more than she deposited, a court could consider her withdrawals to constitute (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 section 548(B) requires. This would be an especially plausible way of proceeding where the Ponzi scheme operator specifically designated the withdrawals as payments of interest, rather than return of principal. But courts tend to credit payments first to principal and then, only once the amount deposited has been withdrawn, will payments be taken to count as "interest." Thus one court, for example, stated that "[i]f a given defendant received less than his undertaking [i.e., his investment], the amounts received should be considered return of principal, regardless of how the parties may have designated them."[101] 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. But, again, if courts were concerned to achieve an even distribution among customers, it would not make sense to credit all payments up to the amount of the deposit(s) as principal; doing so places those payments beyond the reach of the bankruptcy trustee (because the investor has given reasonably equivalent value for these withdrawals, and so they are immune from clawback under section 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 reason for thinking that the fraudulent transfer provision is not intended to ensure an even distribution among creditors emerges when one considers that the bankruptcy code already contains a separate provision that does just this: 11 U.S.C. § 547 states 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 basic idea here is that we don't want a debtor to get to play favorites in determining who among her creditors should have their debts repaid.[102] Instead, all creditors of the same class should 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

[101] Merrill v. Abbott, 77 B.R. 843, 852 n. 14 (D. Utah 1987).

[102] For a classic case that seems to involve a transfer that was both fraudulent and preferential, see Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601). There, the debtor owed both Twyne and C and did not have assets to cover both debts. He secretly gifted those assets he did possess to Twyne, who allowed the debtor to continue using the assets in question. This transaction reflected both an unfair preference for Twyne and a fraudulent conveyance, insofar as it was conducted in secret, and with the intention of hindering C's recovery.

bankruptcy law explains, “preference law … restructures transactions *so as to level out the overall treatment received by similar creditors*.”[103] But if the purpose of Section 547 is to ensure an even distribution, it cannot be that the purpose of Section 548 – again, the fraudulent transfer provision – is to do so as well.[104] To leverage the fraudulent transfer

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[103] 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON, III, NORTON BANKRUPTCY LAW AND PRACTICE § 66:1 (3d ed. 2009) (emphasis added).

[104] *But see* In re Bayou Grp., LLC, 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 savvier 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, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011) (Rakoff, J.), the Madoff trustee's billion-dollar fraudulent-transfer suit against the Mets' owners, and Gowan v. The Patriot Group LLC (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-FEB AM. BANKR. INST. J. 48 (2012).

More relevant here, the *Bayou* court’s assertion that both Sections 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 Section 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 Section 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.” 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 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.

provision (Section 548) for purposes of seeking equity among Madoff's customers, then, renders the preference avoidance provisions (Section 547) superfluous.[105] 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 in the preference avoidance provision – a mere 90 days[106] – in favor of the longer reach-back period

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[105] *But cf.* Clark, *supra* note 92 at 510-513. 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 Sections 547 and 548 along the lines of what I have called the Anti-Fraud 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.

[106] 11 U.S.C. § 547(b)(4)(A). At least one court has decried section 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.

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

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 14 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."). At least some of these welcome this expansive reading. See *id*. Those who have decried the expansion do so on separation of powers grounds, and not on the

of the fraudulent transfer provision – up to 6 years.[107]

All of this to say that the Anti-Fraud reading of Section 548 is on far firmer ground than is the Equitable Distribution 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.'"[108] And a leading 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 look, generally, for their security."[109] Similarly, then-Judge Stephen Breyer, in a First Circuit Court of Appeals decision,

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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, 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

> [Some] [c]ourts ... 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.

[107] Section 548 authorizes avoidance of transfers made only in the two years prior to the declaration of bankruptcy. However, Section 544(b) of the Code allows the trustee to avoid fraudulent conveyances based on state law, 11 U.S.C. § 544(b) (2010), and the New York fraudulent transfer provision allows for a six year reach-back period, McKinney's CPLR § 213 (2004). 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). 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.

[108] 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES, Sec. 289 (rev. ed. 1940) (quoting *In Re Johnson,* 20 Ch. D. 389 (1881)). *See also* Peter L. Borowitz & Richard F. Hahn, *The Troubled Leveraged Buyout: Risks (and Opportunities) Under Fraudulent Conveyance and Other Creditors' Rights Laws*, PRACTISING LAW INSTITUTE: CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 51, 53-54 ("In its original form fraudulent conveyance law 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.").

[109] MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY: CASES AND MATERIALS 387 (3d ed. 2006).

stated that one of the "basic functions" of fraudulent conveyance law was "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."[110] And Breyer's conception has subsequently been endorsed by the Second Circuit Court of Appeals,[111] as well as numerous federal district and bankruptcy courts.[112] In short, according to all of these sources, fraudulent conveyances may be avoided, under contemporary law, *because they are fraudulent*, and not because they risk creating a disparity between creditors of the same class.

With all of that said, even if the bankruptcy code wasn't intended to be used to take money from some innocent Ponzi scheme investors and provide it to others, perhaps we shouldn't object too much to 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 just this line of thinking in defending the clawback suits to the general public – to problematic effect, as we shall now see.

III. UNJUST ENRICHMENT AND STOLEN GOODS

In seeking to justify avoidance actions filed against innocent and (allegedly) knowing investors alike, Picard has 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.'"[113] Or, putting the point even more starkly, he subsequently described the disparity between winners and losers thusly: "For more than 20 years, Bernard Madoff

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[110] Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1511 (1st Cir., 1987). *See also id.* ("[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.").

[111] *See, e.g.*, HBE Leasing Corp. v. Frank, 48 F.3d 623, 634 (2d Cir., 1995); In re Sharp Intern. Corp., 403 F.3d 43 (2d Cir., 2005).

[112] *See, e.g.*, In re Pearlman, 460 B.R. 306, 312+, 23 Fla. L. Weekly Fed. B 102, 102+ (Bankr.M.D.Fla. Jul 13, 2011) (NO. 6:07-BK-761-KSJ, ADV 6:09-AP-53); In re Jeffrey Bigelow Design Group, Inc., 956 F.2d 479, 484+, 26 Collier Bankr.Cas.2d 967, 967+, 22 Fed.R.Serv.3d 371, 371+, Bankr. L. Rep. P 74,478, 74478+ (4th Cir.(Md.) Feb 13, 1992) (NO. 91-1508); In re Aphton Corp., 423 B.R. 76, 94 (Bankr.D.Del. Jan 27, 2010) (NO. 06-10510 (CSS), ADVP 08-50636 (CSS)).

[113] Michael Rothfeld, *Madoff Investors Brace for Lawsuits*, WALL ST. J., July 26, 2010, *available at* http://online.wsj.com/article/SB10001424052748704719104575389141620473502.html.

stole money from some people and gave it to others…."[114] And Picard's lieutenant has echoed this rhetoric as, for example, when he stated that "[t]hose who didn't get their money back are entitled to get it from those who have it."[115]

These statements have great intuitive appeal, as they rely upon an implicit analogy to two well-established doctrines – *viz.* 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's and Sheehan's rhetoric implies that we ought to conceive of the winners like the innocent recipients of ill-gotten gains or stolen goods, in which case we ought – consistent with the doctrines governing unjust enrichment or stolen goods – to compel the winners to return their "winnings" to the losers. And it is not just Picard who seeks to leverage this rhetoric. Trustees charged with recovering assets in the wake of other Ponzi schemes, as well as the Securities Investor Protection Corporation, have also sought to support clawback suits by construing the transfers they seek to avoid as instances of unjust enrichment or stolen goods.[116] It behooves us, then, to consider the force

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[114] *The Madoff Recovery Effort: An Update Call with the Trustee and His Counsel from Baker Hostetler*, March 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 Rappeport, *123 Claims Filed over Madoff Payouts*, FT.COM (Financial Services) (December 1, 2010 12:53 am), 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….'").

[115] *Id.* at *6.

[116] Thus, the receiver appointed by the SEC in the Stanford International Bank fraud has sought to recover money from innocent beneficiaries of the Ponzi scheme by advancing, *inter alia*, a claim that they were unjustly enriched. Receiver's First Amended Complaint Against Certain Stanford Investors ¶¶ 32-42, Janvey v. Alguire, 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009), available at 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 25-26, 36, SIPC v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC), No. 08-01789 (BRL), 2010 WL 694211 (Bankr. S.D.N.Y. Oct.

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 returned to him a benefit gained at his expense by another, if the retention of the benefit by the other would be unjust."[117] A defendant will be found to have been enriched unjustly if each of the following questions receives an affirmative answer: "(i) Was the defendant enriched? (ii) Was it at the expense of the claimant? (iii) Was it unjust?"[118] The defendant who is found to have been enriched unjustly will be required to restitute the plaintiff unless the defendant can marshal an established defense.[119]

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. But this is precisely the question under debate. To see this, 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 a good many years, suddenly goes bust as a result of an extraordinary event that no one could have predicted and for which no one was at fault – imagine, for example, that a meteor strikes the building where Schmadoff had his offices, and destroys the vault in which he happened to be storing half of the money investors had deposited with him, as he prepared to undertake a large stock purchase the next day. (The other half was already invested in the market). Though Schmadoff's firm was appropriately insured, insurance does not cover this contingency; half of the money investors thought they had is now gone. Now, over the years, some investors withdrew more money than they had deposited; 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. 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

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16, 2009), *available at* http://www.madofftrustee.com/document/dockets/000450-519-memorandum-of-law.pdf (search "519" under "Docket #") (last visited Mar. 7, 2012).

[117] Warren Seavey and Austin Scott, *Restitution*, 54 LAW Q. REV. 29, 32 (1938). *See generally* 342 (collecting paradigmatic statements of the doctrine).

[118] PETER BIRKS, UNJUST ENRICHMENT 39 (2005).

[119] *Id.*

Schmadoff winners gain at the expense of the Schmadoff losers?

Or, 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-existant debt,[120] as when A forgets that she has already discharged her debt to B and pays B twice. Clearly, the Madoff case is relevantly different from this paradigmatic case. Other cases involve "failures of consideration, shades of fraud and pressure, and taking advantage of vulnerable people."[121] The second of these three factors looks to be 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."[122] Here, X would be Madoff, C a winner, and D a loser, and the principle would apply just so long as 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: D need not return the money to C if D received the money in exchange for a bona fide purchase. Thus, for example, 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 the proceeds of the meal to the law firm for it supplied the food and drink for which the money paid.[123] Moreover, the result holds even if the Ritz marks up its prices exorbitantly to ensure that its profit margin is, say, ninety percent of the purchase price.[124]

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

So this looks like a case where the law of unjust enrichment would compel the Madoff winners to return their winnings to the Madoff losers.[125] But it is just at this point that the law of unjust enrichment is on

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[120] *See* Birks, *supra* note 9 at 5; *id.* At 73 (referring to this case as "the core of the core" of unjust enrichment doctrine); Dennis Klimchuk, at 82.

[121] Birks, supra note 9 at 40 (citing these, along with cases of mistake, as an exclusive list of unjust factors).

[122] Birks, supra note 9 at 86 (distilling the principle behind the House of Lords' decision in Lipkin Gorman v. Karpnale Ltd., [1991] 2 A.C. 548 (HL)). *Cf.* Zoe Sinel, *Through Thick and Thin: The Place of Corrective Justice in Unjust Enrichment*, 31 OXFORD J. LEG. STUD. 551, 551 (2011) ("Clearly, one should return what one was not meant to receive and for which one gave nothing in return.").

[123] The example is Birk's variation on the *Lipkin Gorman* case, *supra* note 9 at 86.

[124] *Id.*

[125] 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

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"[126] even though the defendant bears no responsibility for the fraud. The rationale in these cases foregrounds the plaintiff's *lack of responsibility* for the transfer; the defendant's lack of responsibility is taken to be irrelevant.[127] But why should this be so? As Kit Barker puts it, "Why is the defendant, who is no more causally implicated in events than anyone else, obliged to 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?"[128] Indeed, one might put the point even more strongly, 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 interest."[129]

One can find two responses to these queries in the scholarly literature on unjust enrichment, but neither is ultimately convincing. First, it has been 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."[130] 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. There remains a problem, however. The prospect, or even fact, 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 to which her punishment conduces – viz., the general deterrence that will make others less likely to commit a similar crime, and the defendant in particular less likely to be victimized by such a crime. Still, because it is the defendant who is singled out for punishment without cause, he is being treated as a mere means, even if he, along with others,

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money withdrawn equal to the principle they had invested. *See, e.g.*, *Katz*, *supra* note 11 at 48 (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).

[126] Kit Barker, *The Nature of Responsibility for Gain: Gain, Harm and Keeping the Lid on Pandora's Box*, *in* THE LAW OF UNJUST ENRICHMENT 146, 162 (Robert Chambers et al. eds., 2009) (citing relevant caselaw).

[127] Barker, *supra* note 126 at 165-66.

[128] *Id.* at 166.

[129] Dennis Klimchuk, *The Normative Foundations of Unjust Enrichment*, *in* THE LAW OF UNJUST ENRICHMENT 80, 97 (Robert Chambers et al. eds., 2009). Klimchuk is here 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).

[130] Klimchuk, *supra* note 129 at 97.

enjoys the benefit in which his treatment results. So the defendant serves as an instrument for the gain, even if the gain is one in which he 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;[131] still, it makes sense to have him "insure" the plaintiff against her loss "because he happens to have an obvious surplus fund"[132] – namely the proceeds deriving from the plaintiff's loss. On this way of thinking, there is said to be a "localized" or "internal" distributive norm operating between the plaintiff and defendant such that fairness (rather than, say, corrective justice) compels return of the money.[133] Whatever the justificatory force of this line of thought in the standard case of unjust enrichment resulting from a fraud in which the defendant has played no role, 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, in which case his withdrawals might not constitute "an obvious surplus fund." In any event, even those who believe that fairness normally dictates return of the transferred funds in these cases recognize an exception where the defendant would suffer harm himself as a result.[134] 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.[135] It is not true of these winners, then, that the money they would be forced to give up constituted a surplus such that giving it up would leave them no worse off at the end of the day.[136] Put differently, fairness does not necessarily compel the result that arises in the standard case of unjust enrichment, and that the Madoff trustee requires.[137]

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[131] Barker, *supra* note 126 at 168.
[132] *Id.*
[133] *See id.* at 167 (referencing 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)).
[134] *See, e.g.*, HANOCH DAGAN, UNJUST ENRICHMENT 40 (2004); Barker, supra note 126 at 168.
[135] *See infra* note 206.
[136] *See* Barker, *supra* note 126 at 168.
[137] 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, *at* 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 "declar[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

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 enrichment involve an injustice. But whether or not these conditions obtain 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 obtain between winners and losers can do so. 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 among the legal rules that just about everyone knows regardless of their level of legal sophistication. The rule dates back to Roman times -- "He who hath not cannot give"[138] – and can be found in the UCC today -- "A purchaser of goods acquires all title which his transferor had or had power to transfer…."[139] – as well as in the UCC's English counterpart -- "[W]here goods are sold by a person who is not their owner, and who does not sell them under the authority with the consent of the owner, the buyer acquires no better title to the goods than the seller had."[140] Yet, notwithstanding the entrenched nature of the rule around stolen goods, it turns out that there is little to support it, and it is largely irrelevant to the Madoff case in any event, I shall now argue.

Why does the law favor the original owner over the good-faith purchaser of a stolen item? There are two kinds of rationale adduced in support of the rule – those grounded in considerations of efficiency, and those grounded in considerations of fairness.

On 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. 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 else purchase insurance to

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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.

[138] *See, e.g.*, HENRY CAMPBELL BLACK, A LAW DICTIONARY CONTAINING DEFINITIONS OF THE TERMS AND PHRASES OF AMERICAN AND ENGLISH JURISPRUDENCE, ANCIENT AND MODERN 813 (1910).

[139] UCC-TEXT APP Y §2-403.

[140] The Sale of Goods (England and Wales) Act, 1979, § 21(1).

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 repose: 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. It is for these reasons that, in civil law countries, the rule goes the other way, with good faith purchasers typically enjoying priority, and original owners denied recovery.

All of that to say that the efficiency-based considerations for the rule of stolen goods are hardly decisive; nor, as we shall now see, are the fairness-based considerations. Fairness looks to favor the original owner because the original owner might have imbued the item with more personal meaning than has the good-faith purchaser. Where the property in question is "personal" on Margaret Jane Radin's conception of that term – where, that is, the property is somehow bound up with its original owner's conception of herself -- it makes sense to return the item to the original owner.[141] 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. The original owner has had the item taken from her against her will.[142] Thus, where, for example, the item was stolen as part of a genocidal campaign – as in cases of Nazi-looted art, for example[143] -- we might say that the original owner has sustained not only a material loss but an expressive injury as well, 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.

Both of these rationales strike me as no more than presumptively compelling: It might well be the case that the more personal attachment, or the more injurious loss, resides on the side of the original owner in most cases. But there will surely be exceptions. Thus, 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

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[141] *E.g.*, Margaret J. Radin, *Property and Personhood*, 34 STAN. L. REV. 957 (1982).
[142] Menachem Mautner, *"The Eternal Triangles of the Law": Toward a Theory of Priorities in Conflicts Involving Remote Parties,* 90 MICH. L. REV. 95, 152 (1991).
[143] *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 five Gustav Klimt paintings that had belonged to her family prior to the Holocause).

family, we might well imagine that his fiancee attaches special significance to the ring in light of the sacrifice that her betrothed undertook to get it for her – significance that might well be just as weighty, if not more so, 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 had been duped into buying a stolen good as part of a scam that exploits a special vulnerability from which the good faith purchaser, and those of her group, suffer. This is the case in instances of affinity fraud, in which the fraudster preys upon others who share ethnic or religious ties.[144] So the good-faith purchaser might have been subject to an expressive, or ethnically-inflected, injury, while the original owner was not. In sum, the fairness rationales appear to provide no more than presumptive reasons for privileging the original owner, and 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, like 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 do not in fact need to think about privileging one or the other of the winner and loser of an investment fraud in the way that we need to think about privileging one or the other of the original owner and good-faith purchaser in the case of a theft. And 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: Although Smith did in fact cash out early, and Jones was left holding the bag, things could have proceeded precisely the other way, with Jones cashing out early, and Smith holding the bag. Moreover, it is not just that either of them *could have been* the victim of fraud; each of them *was* the victim of fraud. This is so not only in those cases where winning investors believed they had money left in their Madoff funds – money representing "profits" that turned out to be fabricated -- but then learned that, on the bankruptcy court's definition of net equity, they would get none of it. Even the investor who liquidated her account and received exactly the amount she believed she had can be said to have been a victim of fraud, insofar as she had invested her money under false pretenses. Both, that is, 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,

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[144] 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." http://www.sec.gov/investor/pubs/affinity.htm.

for which neither bears responsibility. There is then a moral equivalence between Smith and Jones, or between any innocent winner and innocent loser in a Ponzi scheme.

Yet if that's right, then why shouldn't winners and losers share in the losses together? An answer to that question will have to await Part V. Even if it does turn out that, in the abstract, fairness demands loss sharing among Ponzi scheme winners and losers, it is not clear that it would be fair to proceed with the clawbacks, given that we do not require the innocent beneficiaries of other kinds of wrongs to share in the losses that the victims of those wrongs sustain, or so I shall now argue.

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*, and Madoff was unable to satisfy all of their claims at once.

We now know that the financial crisis was precipitated in no small part by acts of wrongdoing. Fraud itself increased in the years preceding the meltdown.[145] Moreover, instances of recklessness, willful blindness and exploitation figure prominently among the acts and events identified as having caused the crisis.[146] Yet the response to the financial crisis is noteworthy not least of all because it has all but eschewed any grand-scale attempt at compensating those who lost money through no fault of their own. In this Section, I seek 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 corporation 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

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[145] *See* Page Perry LLC, *Financial Scams Are Becoming More Common as the Economy Deteriorates*, INVESTMENT FRAUD LEGAL BLOG (Apr. 13, 2009), http:// www.investmentfraudlawyerblog.com/2009/04/financial_scams_are_becoming_m.html (last visited Aug. 8, 2011) ("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.").

[146] *See, e.g.*, THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT XV-XX (2011), *available* at http://www.gpoaccess.gov/fcic/fcic.pdf.

executives, and then only when their companies issue earnings restatements, to correct for earlier mistaken earnings reports.[147] More specifically, three federal statutes permit executive compensation clawbacks, each developed in response to cases of dramatic financial wrongdoing – the Sarbanes-Oxley Act of 2002,[148] passed in the wake of the Enron and Worldcom scandals;[149] the Dodd-Frank Act of 2010,[150] passed in the wake of the subprime mortgage crisis and ensuing financial meltdown in 2007 and 2008;[151] and the Emergency Economic Stabilization Act of 2008,[152] passed in conjunction with the bailout program that the financial meltdown necessitated.[153] The triggering event under each of these is a finding that the corporation in question issued a materially inaccurate earnings statement (SOX, Dodd-Frank and EESA),[154] or otherwise materially failed to comply with a federal securities reporting regulation (Dodd-Frank).[155]

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[147] 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 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 1 at 527-28; SEC 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. Further, Section 308 of Sarbanes-Oxley, the "Fair Funds" provision, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, Id. § 305(b), 116 Stat. 745, 779 (codified at 15 U.S.C. § 78u(d)(5)), grants the SEC authority to seek "any equitable relief that may be appropriate or necessary for the benefit of investors." As Aaron Zimmerman describes, "[i]n 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 investors--more than twice as much as the amount the SEC collected between 1984 and 1992." *Supra* note 1 at 529-30.

[148] Sarbanes–Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 29, 2002).

[149] *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002-2003).

[150] Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173).

[151] *See, e.g.*, DAVID SKEEL & WILLIAM E. COHEN, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2010).

[152] Emergency Economic Stabilization Act of 2008, Division A of Pub.L. 110-343, 122 Stat. 3765, enacted October 3, 2008.

[153] *See, e.g.*, Sandra Seitman, *Uncle Sam's New Piggy Bank: Confronting Crisis Through TARP and Federal Oversight*, BUSINESS LAW BRIEF 53, 53 (2009-2010).

[154] Sarbanes-Oxley, Section 304(a); Dodd-Frank, Section 954; EESA, Section 11(b)(3)(B).

[155] Dodd-Frank, Section 954.

SOX restricts its clawback provisions to the corporation's CEO and CFO;[156] EESA permits clawing back compensation from the CEO and the next twenty highest paid executives;[157] and Dodd-Frank, the most expansive of the three, subjects any executive of the corporation to a clawback action.[158] On the other hand, Dodd-Frank contemplates a less severe clawback than do the other two statutes, with Dodd-Frank restricting the clawback amount to that in excess of what the executive would have earned under the correct earnings statement,[159] while both SOX and EESA permit recovery of all of the targeted executive's incentive-based compensation.[160] The reach back period under Dodd-Frank is the three years preceding the reporting error or failure; under SOX, it is 12 months, and there is no specified reach back period under EESA.[161]

Importantly, these statutes permit clawbacks independent of whether the individual targeted bears a culpable connection to the triggering event.[162] In this way, each of them inflicts its clawback

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[156] *See, e.g.*, Joseph E. Bachelder III, *Clawbacks Under Dodd-Frank and Other Federal Statutes*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Jun. 9, 2011, 9:14 AM, http://blogs.law.harvard.edu/corpgov/2011/06/09/clawbacks-under-dodd-frank-and-other-federal-statutes/.

[157] *See id.*

[158] *See id.*

[159] *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 Section 210S, H.R. 4173-139. 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.

[160] For the relevant provision, see Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 722, 730 (2011).

[161] *See generally* Joseph E. Bachelder III, *Clawbacks Under Dodd-Frank and Other Federal Statutes*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Jun. 9, 2011, 9:14 AM, http://blogs.law.harvard.edu/corpgov/2011/06/09/clawbacks-under-dodd-frank-and-other-federal-statutes/.

[162] *See, e.g.*, *SEC v. Jenkins*, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009) Available at 9 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*, ALERT, 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, August 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

measures on both "innocent" and culpable executives alike.[163] One might then think that these statutes, like the Ponzi scheme clawback actions, stand for the proposition that one ought not to profit from another's wrongdoing, whether or not one is culpable of that wrongdoing. There are nonetheless significant differences between the executive clawback statutes and the Ponzi scheme clawback cases, we shall now see.

As compared with the Ponzi scheme clawbacks, executive clawbacks are at once more compelling, and yet less harsh. Even in cases where the executive did not participate in the false or fraudulent financial accounting, one could argue 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 just 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.[164] Thus she retains whatever financial rewards are owed to her in virtue of what the company did in fact earn, unlike the winning Ponzi scheme investor, who is made to return all of her profits.

Further, even the more severe clawbacks that SOX and EESA license, 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 (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).[165] Moreover, the executive may well not feel the sting of any

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Dodd-Frank Act clawback statute."); Joseph E. Bachelder III, *Clawbacks Under Dodd-Frank and Other Federal Statutes*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Jun. 9, 2011, 9:14 AM, http://blogs.law.harvard.edu/corpgov/2011/06/09/clawbacks-under-dodd-frank-and-other-federal-statutes/. ("EESA §111(b)(3)(B) contains no provision limiting it to cases of misconduct.").

[163] 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).

[164] 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*, THE CONGLOMERATE, Aug. 10, 2009, http://www.theconglomerate.org/2009/08/clawbacks-outrage-and-interpretation.html.

[165] For the reachback period provided by the executive clawback statutes, see *supra* note 161 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 reachback period. *See* Robert J. White,

clawback she faces, as 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.[166] Ponzi scheme investors cannot insure their investments against fraud.

In any event, even while financial regulators are permitted to pursue executive clawbacks, this is a remedy that commentators revile,[167] and from which even the SEC regulators seem to recoil.[168] Between 2006-2009, companies issued 4609 earnings restatements, yet the SEC, pursuant to its authority to seek executive clawbacks under Sarbanes-Oxley, attempted to do so in only 11 cases![169] And while Dodd-Frank's

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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, 358-59 (1991).

[166] Reynolds Holding & Una Galani, *Pushing Back on Clawbacks*, N.Y. TIMES, Dec. 19, 2011, *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, *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 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.

[167] *See, e.g.*, Larry Ribstein, *Punishing Innocent Executives: SOX's Litigation Time Bomb Goes off*, IDEOBLOG (Jul. 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.

[168] *Cf.* Manning G. Warren III, *Equitable Clawback: An Essay on Restoration of Executive Compensation* (bemoaning the under-utilization of a common law doctrine that would allow private individuals to sue executives who had breached their fiduciary duties seeking forfeiture of compensation as a remedy).

[169] *See, e.g.*, Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 722, (2011). Notable cases of corporate wrongdoing in which the SEC took action against the transgressing corporation and filed complaints against executives implicated in the wrongdoing but declined to pursue clawbacks, include the actions the SEC brought against Dell Computers and its CEO and CFO for overstating its earnings from 2002-2006. *See* Securities and Exchange Commission v. Dell Inc., Michael S. Dell, Kevin B. Rollins, James M. Schneider, Leslie L. Jackson, Nicholas A.R. Dunning, Civil Action No. 1:10-cv-01245, *available at* http://www.sec.gov/litigation/complaints/2010/comp21599.pdf. *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. Dell agreed to pay a penalty of $100 million to settle charges by the SEC that it "'manipulated its accounting over an extended period to project financial results that the company wished it

clawback provisions were meant to increase the number of such actions – by allowing them to be brought by shareholders, as well as the SEC – this part of Dodd-Frank has met with substantial criticism,[170] and has not been invoked even in cases involving the failed financial institutions that brought the global markets to the brink of collapse. Thus, as Steven Davidoff writes, "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 $300 million."[171] Finally, even if executive

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had achieved.'" United States Securities and Exchange Commission, Press Release, *SEC Charges Dell and Senior Executives with Disclosure and Accounting Fraud*, Jul. 22, 2010, *available at* http://www.sec.gov/news/press/2010/2010-131.htm. Each of the CEO and CFO "agreed to pay a $4 million penalty to settle the case without admitting or denying wrongdoing, but didn't return any pay," *Clawbacks Divide SEC*, Wall St. J., Aug. 7, 2010, available at http://online.wsj.com/article/SB10001424052748703988304575413671786664134.html, which implies that this was not a true 'clawback'.
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, SEC v. Greenberg, 09 Civ. 6939, SDNY, 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)] 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 SOX. *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.

[170] *See, e.g.*, Donald Delves, *Clawback Requirement Removes Board Discretion*, FORBES, Jul. 14, 2009, *available at* http://www.forbes.com/sites/donalddelves/2011/07/14/clawback-requirement-removes-board-discretion/ (arguing that clawbacks are ill-advised, because they may make accounting departments less likely to uncover errors, for fear that the CEO who is forced to return incentive-based pay will retaliate against the department's employees, or because they may just encourage boards to structure executive pay in a way that doesn't key it to the company's performance even while the rationale behind Dodd-Frank is to better align 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 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).

[171] Steven M. Davidoff, *In F.D.I.C.'s Proposal, Incentive for Excessive Risk Remains*, N.Y. TIMES (DEALBOOK) (Apr. 12, 2011 at 6:00 PM),

clawback actions were to become commonplace, they are still a far cry from *investor* clawback actions, which are the tool of choice in the Madoff trustee's recovery efforts.[172] The difference arises at least in part because the executive cannot plausibly contend, as the innocent Ponzi scheme investor can, that the executive reasonably relied on the veracity of the earnings statement(s), and so the legitimacy of her bonus payment(s) for the year(s) in question. The executive is not a disinterested party, with no access to the relevant financial records, who simply takes the statements, and the money that they engender, at face value.[173] This is not to suggest that there is an implicit kind of culpability that the executive bears – say, negligence or a failure of due diligence – and it is this implicit culpability that licenses the clawback. Instead, the executive may well be genuinely and permissibly ignorant of the financial errors. Still, it is her corporation, and if its earnings statements contain errors it is not untoward to deny her the benefits of the mistake.[174]

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http://dealbook.nytimes.com/2011/04/12/in-f-d-i-c-s-proposal-incentive-for-excessive-risk-remains/.

[172] 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 92 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 to have been 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; so, 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 n.154 ("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.") (internal citation omitted).

[173] One way to put the difference between, on the one hand, the executive's relationship to her company's financial performance and, on the other hand, 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 (DC 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; *see also id.* at 19.

[174] *Cf.* Sepinwall, *supra* note 163 (providing an account that would hold executives responsible for corporate wrongs independent of whether the executives satisfy the traditional hallmarks of individual culpability).

A more promising parallel to the Ponzi scheme clawback case, then, is the circumstance in which an innocent shareholder is made to suffer pecuniary consequences as a result of a wrong committed by the corporation in which she holds shares. It is to that circumstance that I now turn.

B. *Shareholder-Funded Restitution*

I contemplate here two general kinds of case in which shareholders appear to suffer pecuniary consequences as a result of corporate conduct of which they are innocent: The first is the garden-variety case in which the corporation faces a fine or damages award, payment of which 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 will be worth examining this case since one might think that it represents a strand of doctrine in which innocent investors are made to suffer in order to defray the losses of the victims of another's wrong (in this case, the corporation's), and so helps to normalize the clawbacks targeting innocent investors in a Ponzi scheme. The second kind of case does involve shareholder clawbacks – here, creditors of an insolvent corporation that has undergone a leveraged buyout can seek to reclaim from the corporation's former shareholders money they received in selling their shares to the corporation's management-cum-owners in the leveraged buy-out process. I elaborate upon each in turn.

1. *Consequences to Shareholders of Corporate Wrongdoing*

When a corporation finds itself faced with a financial penalty or significant damages award, shareholders might well see the value of their shares drop.[175] This might seem unfair given the traditional separation between ownership and control, which entails that shareholders have no say over the corporation's day-to-day activities,[176] and so no ready means to have prevented the wrongful conduct that precipitated the penalty or judgment. Moreover, the unfairness would be all the more apparent in

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[175] *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….") (footnote 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.").

[176] The classic text articulating this conception of the corporation is ADOLF BERLE & GARDINER MEANS, THE CORPORATION AND PRIVATE PROPERTY (1932).

cases where at least some of the shareholders at the time of redress did not own shares in the company at the time of its wrongdoing, and their share purchase price did not reflect the possibility that the corporation might, at some point in the future, face the penalty or judgment in question (say, because the corporate wrong hadn't been disclosed, or perhaps even discovered, at the time the investor purchased her shares).

To make matters more concrete, consider cases of fraud-on-the-market, where the corporation misstates its financial situation, painting a rosier picture than is warranted. In light of the fraudulent statement, share prices rise. Investors who hold shares in the corporation might choose to sell, to take advantage of the rise in share price; those who buy the shares are then paying an 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. And, if the buying shareholders prevail in their suit, it is the corporation's current shareholders – who might well include the plaintiffs in the suit! – who will suffer, at least if the corporation's share price drops as a result.[177]

One might then be inclined to say that the SEC's actions here have innocent parties 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 those who lost money in 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. To be sure, the company's share price might take a dip, but this is a paper loss unless the shareholder is compelled to sell in the immediate aftermath of the penalty's imposition. Moreover, 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 that is subject to being clawed back can, in principle, have her wages garnished or assets seized, in order to satisfy the trustee's claims against her. And, it is not the loss in share value that compensates the corporation's victims; that is, the money shareholders lose is not 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 (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). For all of these reasons, then, the case in which innocent shareholders sustain a loss in share value as a result of the corporation's restitutionary or compensatory obligations is vastly different from that faced by innocent

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[177] *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Marke*t, 60 U. PA. L. REV. 69, 72-73 (2011).

investors in the Madoff clawback actions, who may be compelled to *return* money that they legitimately thought was theirs for redistribution to the Madoff losers.

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

There is however one kind of a case where a shareholder *can* be made to return money that she made in the market – *viz.* where she has sold her shares as part of a leveraged buyout (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. To purchase the outstanding shares, management often borrows money from a third-party – e.g., a bank – and secures the loan with the target corporation's assets, thereby increasing the liabilities of the target corporation, to the potential detriment of the corporation's existing creditors.[178] As one commentator explains, the corporation's "new debt is likely to be senior secured debt. Thus, by definition, leveraged buyouts adversely affect existing creditors of the company by reducing the assets available for the satisfaction of obligations owed to them."[179]

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.[180] Some commentators and courts have argued that the fraudulent transfer provisions should not extend to the leveraged buyout context.[181] Nonetheless, the vast majority of courts have approved the use of clawback suits against the former shareholders in this context.[182]

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

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[178] *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 (1992); Borowitz & Hahn, *supra* note 108 at 67 and 70-71.

[179] Kathryn V. Smyser, *Going Private and Going Under*, 63 IND. L.J. 781, 786 (1987/1988).

[180] 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.

[181] *See, e.g.*, Baird & Jackson, *supra* note 93; Kupetz v. Wolf, 845 F.2d 842, 848 (9th Cir. 1988).

[182] *See generally* Borowitz & Hahn, *supra* note 108 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 93), see Smyser, *supra* note 179.

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 will reveal important differences, however.

First, it is worth noting that 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. And, 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, so just so 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.[183] Thus, in a world without shareholder clawbacks, a leveraged buyout would be attractive to "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."[184] This is especially true in the case where the target corporation is already financially troubled, as the shareholders couldn't readily sell their shares on the secondary market; a leveraged buyout 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."[185] Moreover, unlike the case in which the corporation incurs more debt in order to fund an entrepreneurial activity, which 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."[186]

Moreover, the existing shareholders are not without the power to promote, or even mandate, the leveraged buyout. In the process, the existing shareholders effectively jump the queue that would exist in the event of a bankruptcy, for 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 whatever value remained after the creditors had been paid; by forcing the corporation to buy back their shares before it declares

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[183] *See* Smyser, *supra* note 179 at 798.
[184] *Id.* at 799.
[185] *Id.* at 798.
[186] *Id.* at 803.

bankruptcy, then, the shareholders enjoy a priority over the company's creditors to which they are not entitled.

The role played by the shareholders in a leveraged buyout is not, then, like the role played by the standard innocent winners in a Ponzi scheme, and instead more like the role played by a group of investors in the scheme who, knowing of the fraud and seeing the scheme approach the brink of collapse, encourage the Ponzi scheme operator to find new investors, or else seek to recruit the new investors themselves.[187] These investors participate in the scheme in a way that makes them complicitous in it;[188] they hardly count as innocent winners.[189] It does not seem at all unfair to require accomplices to the scheme to return any money they have withdrawn; this is just to adhere to the classic dictate that one may not profit from one's own wrongdoing,[190] and instead must redress one's victims.[191] In a similar vein, it is not untoward to ask the former shareholders of a leveraged buyout to return the money they received in the sale of their shares where they encouraged, or perhaps even directed, the sale. Again, all of this suggests that the standard shareholders in a leveraged buyout are situated differently from the innocent investors in a Ponzi scheme.[192] We cannot, then, infer anything

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[187] 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.").

[188] *See, e.g.*, Model Penal Code 2.06(3) (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 commision of the offense fails to make proper effort to prevent [it].").

[189] *But cf.* In re Sharp Intern. 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).

[190] *See, e.g.*, Riggs v. Palmer, 115 N.Y. 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 (1986).

[191] *See supra* note 1.

[192] 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 the shareholder succeeds, as a result of the LBO, 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 can't be accused of having jumped the queue, as it were. In any event, even if the

about the justifiability of clawbacks against innocent Ponzi scheme winners from the now well-established practice of clawing back money from the investors who sold their shares to a corporation in the process of a leveraged buyout where the new corporation ends up going bust.

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. So 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 the clawback suits altogether, and argue that if we are not prepared to have the innocent beneficiaries of wrongdoing restitute the wrongdoing's victims across the board, we should not do so in the Ponzi scheme context alone. But this Part takes the opposite tack, instead arguing in Part V.A that we should recruit all innocent investors in our attempts to make the victims of financial fraud whole; Part V.B begins to develop a proposal for how this might be done.

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

While the innocent winners in a Ponzi scheme case are no less entitled to the "profits" they withdrew than are the losers, neither are they more entitled to it. But 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

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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. *Compare* In re Wolf & Vine, Inc., 77 B.R. 754, 760 (D.C. 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."). Both cases, that is, might well involve an indefensible effort to recoup money in order to defray another's losses.

legitimate investment scheme are entitled to the money they earn on their investment. That, at any rate, 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. 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 and fortune alone chooses the winner entail an obligation, or even a reason, for the winner to share her winnings among all of the game's participants. Thus, for example, we wouldn't 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 ticket-holders.

One clear way to draw the 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 that the winner wins, and that luck alone will determine the winner. But the Ponzi scheme investors reasonably conceived of themselves as sitting in the same boat, as it were; all those invested at the same time would win or all would lose, and whether they would all win or lose was, they believed, a function of the Ponzi scheme operator's investment savvy and not a function of the point in time at which they chose to withdraw their funds – a factor that cannot be said to enhance or diminish their level of desert, given their presumed ignorance of the fraudulent nature of the scheme.[193] All of this to say that, at least in cases of financial wrongdoing where all investors are innocent and yet some profit from the wrongdoing while others lose out, we might well want to have those who have come out ahead help defray the losses of those who would otherwise come out behind.[194]

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,

[193] *See supra* notes 40-50 and accompanying text (presenting reasons to think the Madoff Ponzi scheme winners blamelessly ignorant of his fraud). Other cases in which one set of participants in a game or scheme fare 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.

[194] 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 (quoting one of the Madoff claimants).

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 the same fraud? Why, that is, should the Madoff winners restitute the Madoff losers, rather than investors who were defrauded by, say, Countrywide? Countrywide, we now know, overcharged customers who were desperately hanging on to their home loans, a federal offense for which it paid $108 million in fines;[195] it also discriminated against Black and Hispanic borrowers, for which it paid an additional $335 million fine.[196] 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. And, 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 the share value at the time of sale was inflated as a result of Countrywide's offenses.[197] 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 the fines assessed against Countrywide. But, again, why think that restitution should operate just between the Countrywide investors?

Or 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.[198] Yet no clawbacks are being pursued against these shareholders.

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

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[195] Federal Trade Commission, *Press Release: Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy*, Jun. 7, 2010, *available at* http://www.ftc.gov/opa/2010/06/countrywide.shtm.

[196] *See, e.g.*, Charlie Savage, *Countrywide Will Settle A Bias Suit*, N.Y. Times, Dec. 21, 2011.

[197] *See, e.g.*, Ben Protess, *Bank of America Profit Drops 37%*, N.Y. TIMES (DEALBOOK), Apr. 2011 ("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.").

[198] Lou Davis & Linus Wilson, *Estimating JP Morgan Chase's Profits from the Madoff Deposits*, 14 RISK MANAG. & INSUR. REV. 1, 1 (2011).

winners, help make the Madoff losers whole?[199] 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. But the fact of 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 some other. 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 raised above – why think that those who innocently profit from a fraud bear obligations of restitution that those who profit from a legitimate investment lack?

I now contend that that question has no 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 that, from their perspective, their withdrawals constituted earnings no less legitimate than the earnings reaped by an investor in a genuine investment vehicle. It is on this ground that Judge Rakoff held that innocent investors in Madoff's scheme could avail themselves of the Bankruptcy Code's safe harbor provision,[200] 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."[201] 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.[202] 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 therefore are fully entitled to invoke the protections of section 546(e) [i.e., the safe harbor

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[199] Alan Strudler has argued, in a different context, that one who causes an accident, even if blamelessly, has obligations to compensate the accident's victim that no one else has. Alan Strudler, *Mass Torts and Moral Principles,* 11 L. & PHIL. 297, 322–25 (1992). Strudler surely has the phenomenology right – we typically *feel* especially beholden to one whom we accidentally injure, no matter how much care we exercised. But it is not at all clear why we should credit our reaction as reasonable; it might instead be the case that we fetishize our causal agency, and that we do not in fact bear a greater obligation to compensate the accident's victim than anyone else does. In any event, even if Strudler is right, it is not clear that his account extends to the cases under consideration, for it seems a stretch to say that the winning investors *cause* the losing investors' losses.

[200] Picard v. Katz, 11 Civ. 3605, S.D.N.Y., Sept. 27, 2011. The safe harbor provision is contained in 11 U.S.C. § 546(e).

[201] Katz, supra note 11 at *6.

[202] *See* Picard v. Katz, 11 Civ. 3605 (JSR) (Opinion in Interlocutory Appeal, S.D.N.Y., Jan. 17, 2012) at *10.

provision].”[203] Elsewhere, Rakoff also implies that what matters is the investors’ reasonable belief and, just so long as that belief *is* reasonable, the court must treat the investors as if the belief were true,[204] at least for purposes of the avoidance actions.[205]

Rakoff’s position licenses the thought 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, or on living expenses, or even on extravagant travel[206] – , it might well 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.[207] But more to the point, it is unfair to treat Ponzi scheme winners differently from investors who withdraw money from a legitimate investment vehicle, 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. As one commentator notes, “by what grace of God were many of us fortunate enough not to have relied on a Madoff … or somebody like [him]?”[208] It may be no more than “dumb luck” that separates Ponzi scheme winners from those who

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[203] *Id.* at *7 n. 3.

[204] *See, e.g.*, Picard v. Katz, 11 Civ. 3605 (JSR) (Opinion in Interlocutory Appeal, S.D.N.Y., Jan. 17, 2012) at *7 (“[if] 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).

[205] 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. Henning, *Roller Coaster Ride*, *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.

[206] *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, 09 Cr. 213 (S.D.N.Y. June 15, 2009), *available at* http://msnbcmedia.msn.com/i/CNBC/Sections/News_And_Analysis/_News/__EDIT%20Englewood%20Cliffs/ STOCK%20BLOG/Madoff.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.”).

[207] 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).

[208] Jeffrey M. Lipshaw, *Disclosure and Judgment: “We Have Met Madoff and He Is Ours,”* 35 U. DAYTON L. REV. 139, 139 n.1 (2009).

win in a legitimate investment.[209] And why should luck, let alone dumb luck, play such a decisive role in how one fares?[210] 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? I do not believe we should.

If I am right, one of two implications follows – either we should permit the losses to remain where they fell, or else 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 the losses to remain where they fell 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. I turn now to a preliminary proposal for how this might be done.

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. But these commentators contemplate only intra-scheme restitution – they presume (but don't defend the existence of) a special connection binding the winners of a particular fraud to the losers of that fraud.[211] By contrast, the last Section sought to establish that all of those who innocently win in the market are similarly situated, whether their winnings arise from legitimate or fraudulent investment vehicles. All of them, then, share responsibility for restituting fraud's victims.

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[209] *Id.* at 139.

[210] 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 Clients Greedy?*, L.A. Times (Opinion L.A.) (Aug. 19, 2011, 2:58 PM), http://opinion.latimes.com/opinionla/2011/08/are-bernard-madoffs-victims-greedy.html. *Cf.* Complaint, Haines v. Mass. Mutual Life Insur., at *2 ¶ 3 (Dist. Ct. D.Mass.), *available at* http://clients.oakbridgeins.com/clients/blog/haines.pdf (seeking class action relief against Madoff feeder funds and alleging that "Plaintiffs 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.")

[211] *See* Cherry & Wong, *supra* note 14 at 32-34 (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 129 ("a fundamental principle should be that all victims share the 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.").

Implementing this insight need involve no novel crafting of policy. Instead, one or both of two currently debated tax initiatives would do the trick, effectively raising the money needed to sustain a fraud compensation fund. The first is a financial transactions tax (FTT), also called a Tobin Tax, which would be assessed on most financial transactions, affecting most asset classes.[212]

While the idea for such a tax emerged in the 1970s and was originally conceived as a restraint on currency speculation, calls for adoption of a more encompassing FTT received renewed vigor after the 2008 financial meltdown.[213] The recent enthusiasm for an FTT stems from two policy goals that supporters believe the FTT will serve – first, it will curb "socially useless" short-term equity transactions,[214] and second, it will impose some of the costs of risky bank activity on the banks that contribute to systemic risk.[215] But there is an additional benefit, especially relevant here: an FTT would raise money that could be used to compensate the victims of fraud, and it would be paid for in proportion to the winnings that those who have been successful in the market earn. In this way, it would affirm the moral equivalence between the innocent winners and losers in financial transactions, as well as that 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 FTT, would be to endorse calls to raise the capital gains tax,[216] and, again, 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 else a fraudulent one.

The fraud compensation fund 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, to identify those with a culpable connection to the fraud and

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[212] *See, e.g.*, Edmund Conway, *Joseph Stiglitz calls for Tobin tax on all financial trading transactions*, THE TELEGRAPH, Mar. 15, 2012, *available at* 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. 14, 2012, *available at* http://www.spiegel.de/international/europe/0,1518,820965,00.html.

[213] *See, e.g.*, Volkery, *supra* note 210. The G20 had debated, but failed to agree upon, an FTT at its September 2009 meeting.

[214] *See, e.g.*, Paul Krugman, *Taxing the Speculators*, N.Y. Times, Nov. 27, 2009, at A39.

[215] 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."

[216] *See, e.g.*, Eliot Spitzer, *Pass the Romney Rule!*, SLATE, Feb. 6, 2012, at 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.

pursue clawbacks and punitive damages against them, and to ferret out claimants who knew or should have known about the fraud. But because either scheme would dispense with 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 very broad strokes – much of the details remain to be worked out – it does suggest that there exist ready solutions for ensuring that victims of fraud receive redress while distributing the burdens of restitution to all of those who profit from their investments.

CONCLUSION

We have seen that clawback suits against the innocent beneficiaries of a fraud can neither be sustained by statute nor adequately supported by other doctrines. These suits are aberrant insofar as they alone demand that innocent individuals or entities return money that they reasonably believed was theirs in order to redress another's wrong. Yet the innocent winners in a fraud are no more responsible for the losers' losses than is anyone else. We should not require that the victims of fraud bear their losses alone, but we also 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. All of those who would subject their fates to its whims, and who come out ahead as a result, should share in the responsibility to redress its inevitable messes.