Washington and Lee Law Review

Volume 68 | Issue 3 Article 25

Summer 6-1-2011

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> To the economist embezzlement is the most interesting of crimes. Alone among the various forms of larceny it has a time parameter. Weeks, months, or years may elapse between the commission of the crime and its discovery. (This is a period, incidentally, when the embezzler has his gain and the man who has been embezzled, oddly enough, feels no loss. There is a net increase in psychic wealth.) At any given time there exists an inventory of undiscovered embezzlement in—or more precisely not in—the country's business and banks. This inventory—it should perhaps be called the bezzle—amounts at any moment to many millions of dollars. It also varies in size with the business cycle. In good times people are . . . trusting [] and money is plentiful[, b]ut . . . there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. . . . Commercial morality is enormously improved. The bezzle shrinks. . . . Just as the boom accelerate[s] the rate of growth, so the crash enormously advance[s] the rate of discovery. . . . One of the uses of depression is the exposure of what auditors fail to find. Bagehot once observed: "Every great crisis reveals the excessive speculations of many houses which no one before suspected."
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> —John Kenneth Galbraith, *The Great Crash*.[1]

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* Candidate for J.D., Washington and Lee University School of Law, May 2012; B.S. Wake Forest University, 2009. I would like to thank Professor Doug Rendleman for introducing me to this topic, serving as my advisor, and helping shape and guide my writing throughout the drafting process. I also would like to express my gratitude to Professor Margaret Howard for sharing her insights on the Bankruptcy Code and for her assistance in polishing my multiple drafts.

1. JOHN KENNETH GALBRAITH, THE GREAT CRASH 137–40 (Houghton Mifflin Co. 3d ed. 1972) (1954).

I. Introduction

Surprising to all, but perhaps those familiar with Galbraith’s critique of the 1929 stock market crash, the 2008 banking crisis revealed prolific investment fraud. Among those exposed was "a former chairman of the NASDAQ Stock Market and a force in Wall Street trading for nearly 50 years," Bernard L. "Bernie" Madoff, who was thought to have a sterling reputation.[2] In today’s market, financial fraud is increasingly

2. *See* Amir Efrati, Tom Lauricella & Dionne Searcey, *Top Broker Accused of $50 Billion Fraud*, WALL ST. J., Dec. 12, 2008, at A1, *available at* http://online.wsj.com/article/SB122903010173099377.html (noting that prior to his arrest,

prevalent,[3] and just as Galbraith foreshadowed, fraudulent financial schemes are collapsing more frequently given the current economy.[4] Ponzi schemes[5] are no exception. According to the Associated Press, the number of Ponzi schemes uncovered nearly quadrupled from 2008 to 2009 alone.[6] Though the Securities and Exchange Commission (SEC) denies that there has been a "dramatic upswing in terms of the number of [Ponzi scheme] cases,"[7] the agency's deputy director of public affairs, John Heine, admits that the SEC does not keep official statistics on Ponzi schemes.[8] Instead,

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Madoff was a "longstanding leader in the financial-services industry with an unblemished record").

3. *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.") (on file with the Washington and Lee Law Review).

4. *See id.* ("The down market 'exposes more of those frauds' . . . ."); 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.").

5. Gradwohl & Corbett, *supra* note 4, at 183–84 ("The term 'Ponzi scheme' has achieved an established position of instant recognition in American jurisprudence and a certain degree of infamy in everyday English parlance."). The term "Ponzi scheme" is derived from Charles Ponzi, the operator of a fraudulent investment program, which collapsed in the 1920s. *See* Cunningham v. Brown, 265 U.S. 1, 7–9 (1924) (discussing the collapse of Ponzi's fraudulent investment program). In the legal context, a Ponzi scheme is defined by Black's Law Dictionary as "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors . . . ." BLACK'S LAW DICTIONARY (9th ed. 2009).

6. *See* Gary D. Halbert, *Record Year For Ponzi Schemes*, INVESTOR INSIGHT (Jan. 19, 2010), http://www.investorsinsight.com/blogs/forecasts_trends/archive/2010/01/19/record-year-for-ponzi-schemes.aspx (last visited Aug. 8, 2011) ("According to recent research by the Associated Press (AP) . . . more than 150 Ponzi and other fraudulent investment schemes were exposed in 2009, compared to only 40 or so such scams uncovered in 2008.") (on file with the Washington and Lee Law Review).

7. *U.S. SEC Says Magnitude of Ponzi Schemes Growing*, DALJE.COM (Feb. 6, 2009, 6:10 PM), http://dalje.com/en-economy/us-sec-says-magnitude-of-ponzi-schemes-growing/231770 (last visited Aug. 8, 2011) (quoting a speech by Donald Hoerl, director of the SEC's Denver office, given at Practising Law Institute's annual SEC Speaks conference) (on file with the Washington and Lee Law Review).

8. *See* Robert Chew, *Beyond Madoff, Ponzi Schemes Proliferate*, TIME MAG. (Jan. 23, 2009), http://www.time.com/time/business/article/0,8599,1873639,00.html (last visited Aug. 8, 2011) (explaining that official statistics are not kept because "[t]here are too many

what SEC officials have observed as different is "the magnitude of the Ponzi schemes" being perpetrated.[9] While Madoff is certainly the most notorious of the Ponzi scheme operators,[10] other high dollar operations have been discovered in his wake.[11] Given the proliferation and growing magnitude of Ponzi schemes, it is important that possible avenues of investor recovery be examined.

This Note first examines the increasing prevalence of financial fraud and the proliferation of Ponzi schemes. Part II outlines the possible ways that investors can recover when investments are lost in a Ponzi scheme: SIPC coverage, restitution from the wrongdoer, or through tracing and restitution from unjustly enriched third parties. Part II also explains that recovery is uncertain due to the limited protection offered by the SIPC, the likely inadequacy of any financial recovery from the erring fiduciary, and the lack of coherently-developed tracing and restitutionary law. Part III further expounds upon tracing, a tool utilized to identify assets that can be claimed by the creditors (former investors) of the erring fiduciary. It then analyzes the utilization of tracing fictions and the necessity of suspending tracing in favor of pro rata distribution when commingled funds render individual tracing impossible. Part IV details the avoidance powers of the bankruptcy trustee through fraudulent transfers, both actual and constructive, and through preferential transfers. Part V contemplates the

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variations . . . [i]t's hard to categorize a Ponzi vs. a pyramid scheme vs. something else") (on file with the Washington and Lee Law Review).

9. *U.S. SEC Says Magnitude of Ponzi Schemes Growing*, *supra* note 7.

10. *See* Gradwohl & Corbett, *supra* note 4, at 188 ("While the Ponzi scheme engineered by Bernard L. Madoff Investment Securities LLC may end up being the largest fraud in terms of dollars lost, it is not unique."); *see also* Danny King, *JPMorgan Faces Lawsuit over Madoff Fraud*, DAILY FIN. (Dec. 2, 2010, 6:30 PM), http://www.dailyfinance.com/story/investing/jpmorgan-faces-lawsuit-over-madoff-fraud/19742389/ (last visited Aug. 8, 2011) (noting that Madoff's $65 billion dollar fraud was the largest Ponzi scheme in U.S. history) (on file with the Washington and Lee Law Review).

11. In February 2009, the SEC charged Robert Allen Stanford with running an $8 billion fraudulent investment scheme. *See* U.S. Securities and Exchange Commission, *Press Release: SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme* (Feb. 17, 2009), http://www.sec.gov/news/press/2009/2009-26.htm (last visited Aug. 8, 2011) (detailing the charges against "Stanford and three of his companies," which centered around his operation of an "$8 billion [fraudulent] CD program") (on file with the Washington and Lee Law Review); *see also* Leslie Wayne, *Troubled Times Bring Mini-Madoffs to Light*, N.Y. TIMES, Jan. 28, 2009, at B1, *available at* http://www.nytimes.com/2009/01/28/business/28ponzi.html (noting, among other Ponzi schemes uncovered in 2009, a $380 million Ponzi scheme run by Nicholas Cosmo, a $23 million scheme run by George L. Theodule, and a $25 million scheme operated by James G. Ossie).

shortcomings of the current statutory scheme of fraudulent and preferential transfers. It considers how courts have misapplied the fraudulent transfers statute as written by abrogating the good faith defense and how the preferential transfer statute simply reallocates where an arbitrary line regarding the ability to recover is drawn. Part V also looks at the discretion given to the trustee and the resulting inequity and increased uncertainty in the law.

Last, Part VI gives an overview of possible ways to promote predictability in the law. It examines proposed legislation limiting clawbacks and extending SIPC protection, the ability of Congress to amend the fraudulent or preferential transfer statutes, and the introduction of contractual clawback provisions into investment agreements. Part VI then suggests an amalgam of the current proposals, in addition to other actions, as a practicable solution. By allowing pro rata distribution only when tracing is unworkable, traditional property and restitution rules will be observed. By affirming a subjective good faith standard, and introducing "change of position" as an affirmative defense from clawbacks, the reachback period can be statutorily extended back to the inception of the Ponzi scheme while still protecting good faith investors. The introduction of pecuniary protection for whistleblowers promotes investor diligence and makes frauds more likely to be caught in the earlier stages. These changes will promote predictability in the distribution of assets after Ponzi schemes enter bankruptcy while effectuating a more equitable distribution between all investors, promoting the underlying equal-treatment goal of the Bankruptcy Code, and upholding traditional restitutionary principles.

II. Avenues of Investor Recovery After Ponzi Schemes Enter Bankruptcy

A. SIPC Coverage

Ponzi schemes are rarely perpetrated by "legitimate" brokers, but in Madoff's case, he was a licensed broker, and his brokerage firm was a member of the Securities Investor Protection Corporation (SIPC).[12] The SIPC touts itself as "the investor's first line of defense in the event a

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12. *See* Jerry J. Campos, *Avoiding the Discretionary Function Rule in the Madoff Case*, 55 LOY. L. REV. 587, 591–92 (2009) (noting that Madoff's firm, Bernard L. Madoff Investment Securities LLC, "was a broker-dealer and investment advisor firm registered under the SEC which conducted investment advising services, market making services, and proprietary trading services").

brokerage firm fails owing customers cash and securities that are missing from customer accounts," and investors assumed that the SIPC would step in to cover part of their stolen funds.[13]

Through the Securities Investor Protection Act (15 U.S.C. §§ 78aaa-*lll*),[14] Congress created SIPC in 1970[15] as a "response to the financial crisis in the securities industry in the late 1960s."[16] The SIPC purports "to protect customers of broker-dealers and maintain confidence in the United States securities markets."[17] It does not account for losses due to market fluctuations or the decline in value of securities.[18] Instead, its purpose is to "insure brokerage firms just as the FDIC ensures bank accounts, but . . . only against theft or misappropriation," bringing Madoff's behavior exactly within the confines of the SIPC's intended purpose.[19] The legislative history of the Act and its subsequent amendments clarify that investors were intended to be protected, even if the securities were "hypothecated, misappropriated, never purchased, or even stolen . . . ."[20]

However, the SIPC does not cover all types of investments,[21] nor does it cover victims who invested indirectly through a feeder fund as they fail to

13. Securities Investor Protection Corporation, *Our 39-Year Track Record for Investors*, http://www.sipc.org/who/sipctrackrecord.cfm (last visited Aug. 8, 2011) (on file with the Washington and Lee Law Review). The SIPC provides $500,000 in protection per investor, which includes a $250,000 maximum allowance for cash claims. *See* Securities Investor Protection Corporation, *Brochure*, http://www.sipc.org/how/brochure.cfm (last visited Aug. 8, 2011) (outlining the protection provided to customers) (on file with the Washington and Lee Law Review).

14. Securities Investor Protection Corporation, *SIPC Statute and Rules*, http://www.sipc.org/who/statute.cfm (last visited Aug. 8, 2011) (on file with the Washington and Lee Law Review).

15. Securities Investor Protection Corporation, *The SIPC Mission*, http://www.sipc.org/who/sipcmission.cfm (last visited Aug. 8, 2011) (on file with the Washington and Lee Law Review).

16. WILLIAM L. NORTON, JR., 4 NORTON BANKR. L. & PRAC. 3D § 87:9 (2011).

17. *See* Sec. Investor Prot. Corp. v. BDO Seidman, L.L.P., 746 N.E.2d 1042, 1045 (N.Y. Ct. App. 2001) (holding that the SIPC did not have a valid cause of action for negligent misrepresentation against accounting firm BDO Seidman because the SIPC was a non-privy third party).

18. *All Things Considered: SIPC May Rescue Madoff Victims*, NPR, Dec. 31, 2008, *available at* http://www.npr.org/templates/story/story.php?storyId=98913273 (explaining that the SIPC does not "cover market risk or the simple decline of the value of securities").

19. *Id.*

20. S. REP. NO. 95-763, at 2 (1978); H.R. REP. NO. 95-746, at 21 (1978).

21. *See* Securities Investor Protection Corporation, *What SIPC Covers . . . What it Does Not*, http://www.sipc.org/how/covers.cfm (last visited Aug. 8, 2011) (noting that the SIPC does not cover currencies, commodity futures contracts, investment contracts, or fixed annuity contracts that have not been registered with the SEC) (on file with the Washington

meet the definition of "customer" in section 78*lll*(2) of SIPA.[22] Many of Madoff's victims do not qualify for reimbursement from the SIPC due to regulatory restrictions, particularly the third party limitation.[23] Even those investors whose claims are accepted may only recover up to the modest statutory limit, and only after agreeing to substantial conditions.[24]

The SIPC was severely underfunded to cover the losses resulting from Madoff's scheme[25] and has limited claims to the amount actually invested, not the amount shown on the victim's most recent statement.[26] This approach, "referred to as the 'net principal' theory or the 'equity theory,' espouses the idea that the measure of bankruptcy claims should be a matter of equity where illegal contracts or massive fraud [are] involved."[27]

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and Lee Law Review). While individuals who invest in these exchanges certainly do not expect their investments to fuel a Ponzi operation, such investors did not rely on SIPC coverage and presumably were aware of and accepted the higher-risk nature of their investment.

22. Trustee's Fourth Interim Report for the Period Ending September 30, 2010, at 8, Securities Investor Protection Corp. v. Madoff (*In re* Madoff), Adv. Pro. No. 08-1789 (BRL) (S.D.N.Y. 2010), *available at* http://www.madofftrustee.com/documents/FourthInterimReport.pdf.

23. *See* Bernard L. Madoff Investment Securities LLC Liquidation Proceeding, *Claims & Recovery Status* (Aug. 9, 2011), http://www.madofftrustee.com/Status.aspx (last visited Aug. 9, 2011) (noting that as of August 5, 2011, only 14.64% of claims had been approved and 66.45% were denied as third party claims) (on file with the Washington and Lee Law Review).

24. *See* Campos, *supra* note 12, at 602 (noting that investors "are capped in what they can receive from the organization and face a labyrinth of conditions and strictures on actually getting money from the organization").

25. *See* Rachelle Younglai, *Madoff Victims Seek Help from Congress*, REUTERS (Dec. 9, 2009, 6:07 PM) http://www.reuters.com/article/idUSN0912808120091209 (last visited Aug. 8, 2011) ("SIPC is underfunded and has never had to deal with a liquidation the size of Madoff's brokerage.") (on file with the Washington and Lee Law Review); *see also* Fourth Interim Report, *supra* note 22, at 11:

> As of September 30, 2010, the Trustee . . . committed to pay approximately \$728 million in cash advances from SIPC. This is the largest commitment of SIPC funds in any one SIPA liquidation proceeding and greatly exceeds the total aggregate payments made in all SIPA liquidations to date. . . . The total over-the-limits claim amount—the amount by which allowed customer claims exceed the committed SIPC advances—is \$4.9 billion.

Id.

26. *See* Younglai, *supra* note 25 (noting that the SIPC, SEC, and bankruptcy trustee all agree that "customer claims should be based on how much money the victim invested, not the amount the victim thought he had made from Madoff's fictitious investments").

27. John Clemency & Scott Goldberg, *Ponzi Schemes and Claims Allowance*, 19-9 AM. BANKR. INST. J. 14, 14 (2000). On March 1, 2010, the bankruptcy court handling Madoff's liquidation adopted the Trustee's determination that customer claims be calculated using the "equity theory." *In re* Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 141, 143

However, prior to Madoff, the SIPC took the position that the appreciated value of the investment was protected. The "reasonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional reality."[28] The president of the SIPC, Steven Harbeck, testified at a trial "that SIPC covers appreciation in customer accounts . . . 'even if the securities were never purchased.'"[29] This change in approach is particularly troublesome because a primary benefit of investing with an SIPC certified broker is to be insured against malfeasance.[30] The SIPC-certified broker is also subject to regulation by the SEC, which should prevent, and at a minimum catch, fraudulent schemes early.[31] The SEC failed investors on both counts, due to its underfunding and inability to cover losses, as well as its failure to follow up on Madoff, despite receiving multiple credible tips that his business venture was not legitimate.[32] Consequently, even investors who believed that they acted prudently by investing with a licensed brokerage firm are minimally, if any, better off than those who invest in programs outside of SIPC protection and SEC regulation.

Because the SIPC, the supposed "first line of defense," has failed to make investors whole,[33] defrauded victims have turned to restitutionary remedies. Though restitution scholarship has, at least arguably, "been out of fashion for nearly one hundred years,"[34] its ability to adapt to contemporary

(Bankr. S.D.N.Y. 2010), *aff'd*, 09-5122-bk, 2011 WL 3568936 (2d Cir. Aug. 16, 2011) ("[E]quity dictates that the Court implement the Net Investment Method."). The bankruptcy court certified an immediate appeal to the Second Circuit Court of Appeals. *In re* Bernard L. Madoff Inv. Sec. LLC, 09-5122-bk, 2011 WL 3568936, at *4 (2d Cir. 2011). On August 16, 2011, the Second Circuit affirmed the decision of the bankruptcy court and upheld the Trustee's method of determining customer claims in the context of a Ponzi scheme. *Id.* at *8 ("The extraordinary facts of this case make the Net Investment Method appropriate, whereas in many instances, it would not be.").

28. Paul Sinclair & Brendan McPherson, *The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part IV*, 29-4 AM. BANKR. INST. J. 18, 69 (2010) (citations omitted).

29. *Id.* at 69 (quoting Hearing Transcript at 37–38, *In re* New Times Sec. Servs., Inc., 371 F.3d 68 (Bankr. E.D.N.Y. 2000)).

30. *See* Younglai, *supra* note 25 ("'We have a mess on our hands. We have a large group of American investors who were robbed by Madoff, abused by the government and system into thinking they were insured,' said Democratic Representative Gary Ackerman.").

31. *See* Campos, *supra* note 12, at 604 ("[T]he SEC is concerned with providing investors important market-related information, maintaining fair dealing among the players, and *most importantly* protecting against fraud." (emphasis added)).

32. *See infra* notes 188–91 and accompanying text (discussing the inconsistencies reported to the SEC and the agency's failure to investigate).

33. Campos, *supra* note 12, at 602 ("[R]estrictions on the SIPC fund's disbursements and the reality of large Ponzi schemes often dictate an insufficient recovery.").

34. Chaim Saiman, *Restating Restitution: A Case of Contemporary Common Law*

needs[35] has placed restitutionary law at the forefront of recovering the misappropriated funds that are making today's headline news.[36]

B. Restitution from the Erring Fiduciary

Although the remedy of rescission[37] is typically available in instances of fraud,[38] this does not hold true in the context of a bankrupt Ponzi scheme.[39]

Conceptualism, 52 VILL. L. REV. 487, 528 (2007).

35. *See* Doug Rendleman, *When Is Enrichment Unjust? Restitution Visits an Onyx Bathroom*, 36 LOY. L.A. L. REV. 991, 1001 (2003) ("[C]ourts use common law techniques to decide unprovided-for disputes and shape restitution doctrines to contemporary needs . . . .").

36. *See* Mark T. Cramer & R. Alexander Pilmer, *Swindlers' List: Formal Dissolution Proceedings Are Usually Necessary to Sort Through the Wreckage of Failed Ponzi Schemes*, 32 L.A. LAW., June 2009, at 22 ("Thanks to Madoff, Ponzi schemes are now part of the mainstream lexicon and are no longer solely the obscure subjects of court opinions and law review articles. Indeed, talk of Ponzi schemes seems to dominate not only the headlines but also late-night talk shows . . . .").

37. *See* BLACK'S LAW DICTIONARY (9th ed. 2009) (defining rescission as "[a] party's unilateral unmaking of a contract for a legally sufficient reason").

38. *See* 73 AM. JUR. 2D *Support of Persons* § 35 (2010) ("[C]ancellation is not available unless there are special circumstances affecting the adequacy of other remedies, such as fraud or insolvency on the part of the grantee rendering cancellation the appropriate relief."). However, "[t]he remedy of cancellation . . . [or] rescission . . . is not one of absolute right and it is subject to the court's sound discretion . . . to be exercised in accordance with what is reasonable and just under the particular circumstances." *Id.*

39. *See* Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265, 285–86 (1998) (explaining why rescission is not an appropriate remedy when a creditor is defrauded in a Ponzi scheme). Consider the following scenario by Andrew Kull:

> Peter and Paul have both been victims of [an investment scheme] fraud. Because he remitted funds to Ponzi just before the swindle was exposed, Peter is able to trace his money into Ponzi's bank account; Paul's funds were remitted earlier and are untraceable. Ponzi is now in bankruptcy and Peter wants restitution of the traceable funds from the bankrupt estate. He offers the usual argument about second-order restitution: Ponzi's trustee should not be distributing Peter's property (the traceable portion of Peter's investment, Peter having rescinded the transfer for fraud) to pay Ponzi's creditors. But Ponzi's creditors are defrauded investors just like Peter. Because Peter cannot properly differentiate his claim against Ponzi from that of the other creditors, his claim to priority fails. . . . [I]n the Ponzi scenario, neither Peter nor Paul has voluntarily extended credit to the debtor. Both were defrauded; each asserts a right to rescind. Instead of a problem in second-order restitution between a dispossessed owner and a creditor of the transferee, the contest is between conflicting claims of ownership—that is to say, between competing restitution claims. Between claimants similarly situated, the equities of restitution (like the equities of bankruptcy) favor ratable distribution.

Nonetheless, it is fundamental that a "person who is unjustly enriched at the expense of another is subject to liability in restitution."[40] The right of the individual creditors to recover from the wayward fiduciary is indisputable.[41] However, it is likely that the scheme collapsed due to insufficient assets,[42] and the typical "perpetrator[] lack[s] the financial wherewithal to repay the victims of the scheme. . . . [T]he [misappropriated] money dissipates for a variety of reasons."[43] In Madoff's case, for example, his personal assets account for less than 5% of the actual losses, and an even more trivial percentage of the paper losses.[44] Though investors are entitled to restitution from the erring fiduciary, the insolvency of the scheme and its operator precludes meaningful recovery and forces the former investors to pursue other restitutionary remedies.[45]

C. Restitution Through Tracing

The only viable remaining option available to defrauded creditors is tracing,[46] an option that is often misunderstood within the context of restitutionary law.[47] The lack of clarity is not surprising given the

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Id.

40. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 (2011).

41. *See* RESTATEMENT (FIRST) OF RESTITUTION § 1 (1937) ("A person who has been unjustly enriched at the expense of another is required to make restitution to the other.").

42. *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (1998) ("[I]t is not uncommon for the estates of bankrupt Ponzi schemes to have very few physical or liquid assets."). For example, Madoff was candid about his lack of financial resources when his scheme unraveled, stating that his business had "absolutely nothing" in terms of assets. Bureau of National Affairs, *SEC, DOJ Charge Wall St. Veteran Over Multi-Billion Dollar Ponzi Scheme*, 40 SRLR 2049 (Dec. 15, 2008) ("Madoff said his business was insolvent and had been so for years.").

43. Gradwohl & Corbett, *supra* note 4, at 205.

44. *See* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 394 (2009) ("[T]he shortfall is staggering given that authorities have located only about $830 million in assets belonging to Madoff . . . .").

45. *See id.* at 395 ("[A]lthough the losing investors can turn to the courts to hold the operator of the fraud accountable, they are often forced to look elsewhere because the scheme and the operator are insolvent.").

46. BLACK'S LAW DICTIONARY (9th ed. 2009) (defining tracing as "[t]he process of tracking property's ownership or characteristics from the time of its origin to the present").

47. *See* ANDREW BURROWS & EWAN MCKENDRICK, CASES AND MATERIALS ON THE LAW OF RESTITUTION 663 (1997) ("It is extremely difficult to pinpoint precisely what tracing

nuances (and resulting misapplication) of restitutionary law,[48] as well as the lack of scholarly attention restitutionary law receives as a whole.[49] Judges and practitioners simply are not well versed in restitutionary law.[50] The interplay between the common law of restitution and the statutory law of bankruptcy is particularly cloudy; in the words of Andrew Kull, the reporter for the American Law Institute's (ALI) recently published Restatement (Third) of Restitution & Unjust Enrichment: "The contemporary treatment of restitution in bankruptcy has become confused and haphazard because the subject is not addressed by the Bankruptcy Code."[51]

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is concerned with and what its role is within the law of restitution.").

48. *See* Doug Rendleman, *Restating Restitution: The Restatement Process and Its Critics*, 65 WASH. & LEE L. REV. 933, 936 (2008) ("Restitution is an essential and nuanced common law area. But many smaller American states lack a decision on particular restitution points. States, large and small, have muddled restitution analysis or have made just plain incorrect restitution decisions. Many lawyers, judges, and professors misunderstand and misstate basic restitution principles.").

49. *See* Chaim Saiman, *Restitution and the Production of Legal Doctrine*, 65 WASH. & LEE L. REV. 993, 994 (2008) ("[I]n American legal discourse restitution sits at the backwaters of the academic and judicial consciousness . . . .").

50. Kull, *supra* note 39, at 267 ("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.").

51. *Id.* at 265–66. Kull further explains:

> Scarcely anyone in the United States understands what restitution is about, to begin with, and the particular role of restitution in bankruptcy is further obscured by the way in which American commercial law has been codified. Unlike the comprehensive framework of a continental legal code . . . the Bankruptcy Code [was] drafted as [a] common-law statute[]. In theory, at least, [it] displace[s] the preexisting common law only to the extent [it] alter[s] it, and [it] presume[s] the continued existence of this background law to govern every question not otherwise resolved. In practice it does not work quite like that. Lawyers and judges who deal regularly with commercial materials come to expect that any problem worth arguing about has been made the subject of an express statutory provision, their usual task being to locate and explicate the relevant statutory language. In consequence, the neglected background law recedes still further—until we reach a point at which the most orthodox legal proposition, if not tied to a specific code section, may actually be challenged as spurious.

Id. at 266–67.

Though tracing is described as both a tool[52] and a remedy,[53] it is best understood as a restitutionary tool.[54] Tracing comes into play when a pyramid scheme enters bankruptcy (or an equivalent dissolution).[55] A trustee is appointed to collect assets.[56] The assets available to be distributed to investors are pinpointed and identified through tracing. Tracing allows the defrauded investor to find, and thus recover, assets that are no longer held by the wrongdoer and are now held by third parties. Once the assets are returned to the estate, 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."[57] Though tracing is often suspended in favor of pro rata distribution in Ponzi schemes,[58] lower courts are given great discretion in deciding whether to apportion funds based on tracing fictions[59] or to distribute funds pro rata.[60] The hands-off standard of review has led to a

52. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (2011) ("Tracing is neither a source of liability nor a distinct restitutionary remedy. Rather, tracing is an adjunct remedial device or technique . . . .").

53. *See* Dale A. Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172, 184 (1983) ("[T]racing is viewed as a remedy . . . implemented through a number of more specific remedial devices . . . ."). It is worth noting that the amended Article 9 of the Uniform Commercial Code no longer addresses tracing in § 9-306. *See* U.C.C. § 9-306 (2005). U.C.C. § 9-315(b)(2) does allow a secured party to trace proceeds "by a method of tracing, including application of equitable principles, that is permitted under law other than this article." U.C.C. § 9-315 (2005).

54. *See* LIONEL D. SMITH, THE LAW OF TRACING 13 (Oxford University Press 1997) ("The distinction between tracing and claiming is obscured when tracing is referred to as a 'right' or 'remedy.' When the exercise of tracing is properly distinguished from the making of claims, it is clear that the exercise of tracing is neither right nor remedy."); Peter Birks, *Trusts in the Recovery of Misapplied Assets: Tracing, Trusts, and Restitution*, *in* COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 149, 157 (Ewan McKendrick ed., 1992) ("[T]racing should be understood as a process of identification and no more. It is not in itself a remedy."); BURROWS & MCKENDRICK, *supra* note 47, at 664 ("[T]racing is a technique . . . it follows that it is neither a ground for restitution nor a remedy.").

55. *See* Cramer & Pilmer, *supra* note 36, at 24 ("Failed Ponzi schemes often end up in bankruptcy, SEC receivership, Securities Investor Protection Corporation (SIPC) liquidation, or other formal dissolution proceedings. . . . Depending on the circumstances, the personal estates of Ponzi operators and related business entities may file for liquidation in a bankruptcy or through a receiver . . . .").

56. *See id.* ("Trustees and receivers share the same objective—namely, to return as much money as possible to the victims of the scheme.").

57. Saiman, *supra* note 49, at 1011 (citations omitted).

58. *See infra* notes 94–118 and accompanying text (explaining the justifications for and operation of pro rata distribution).

59. *See infra* notes 85–93 and accompanying text (discussing the use of tracing fictions).

60. *See* Saiman, *supra* note 49, at 1013 ("[A] number of [appealed] cases have expressed

lack of consistency in "cases pitting the interests of competing claimants to a limited pool of assets."[61] Due to the emphasis on the trial court's equitable powers to decide the proper remedy, developed case law is limited.[62] Similarly, the power of the bankruptcy trustee to recover transfers to earlier investors, and the defenses available to those earlier investors, continue to develop and remain a source of confusion.[63] In particular, recent applications of the trustee's avoidance power have been alleged to be "grossly inequitable and inconsistent with existing . . . law."[64] Because the law is not settled,[65] the bankruptcy court's approval of the trustee's formula is often appealed, making the recovery process longer and more costly for the victims of the fraud.

III. Tracing, Tracing Fictions, and Suspension of Tracing in Favor of Ratable Distribution of Commingled Funds

When a pyramid scheme collapses and the operator "becomes a debtor under the Bankruptcy Code, the bankruptcy trustee must collect whatever assets are available in order to pay both the investors who lost money and

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near-total agnosticism . . . candidly stating that the district court would be within its rights to apportion the funds using either the 'tracing fictions' or pro rata method, so long as the net result was reasonable.").

61. *Id.* at 1003.

62. *Id.* at 1013–14. As explained by Chaim Saiman:

> [I]nstead of presenting arguments for specific distribution plans on the basis of the law of restitution, [most] cases [regarding tracing and restitution] argue for a hands-off standard of review. As a result, the analytic heavy lifting and virtually all the citation of legal authorities relate to the law of the standard of review rather than to the law of restitution. To the extent there is any "law" in these cases, it is the law governing when a court is within its rights to exercise its discretion.

Id.

63. *See* Kathy Bazoian Phelps, Hon. Steven W. Rhodes, Brenda Moody Whinery & Daniel R. Williams, *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.").

64. Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis*, 72 TEX. B.J. 922, 923 (2009).

65. *See supra* notes 49, 63 (explaining that this area of the law has historically been unanalyzed and is still developing).

any other creditors of the estate."[66] The assets available to be distributed to investors are pinpointed and identified through tracing. Tracing is typically suspended as between equally innocent investors in cases of commingled funds,[67] but to understand the reasons for and necessity of suspension, an understanding of tracing and the development of the pertinent law is important.

Tracing is most easily understood in the context of constructive trusts or equitable liens. Both are considered traditional equitable remedies to prevent unjust enrichment.[68] In the words of Justice Cardozo, "[a] constructive trust is the formula through which the conscience of equity finds expression."[69] Under a constructive trust theory, the wrongdoer is deemed to hold the absconded property "in trust" for the claimant.[70] An equitable lien secures the value of the misappropriated property by attaching to property owned by the wrongdoer.[71] Constructive trusts and equitable liens "are similar in that they are available only when the plaintiff can establish some connection between the benefit conferred and an identifiable asset held by the defendant at the time restitution is sought."[72] Often the claimant can choose which remedy to pursue:

> Where a person wrongfully disposes of property of another knowing that the disposition is wrongful and acquires in exchange other property, the other is entitled at his option to enforce either (a) a constructive trust of the property so acquired, or (b) an equitable lien upon it to secure his claim for reimbursement from the wrongdoer.[73]

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66. McDermott, *supra* note 42, at 158.

67. *See infra* notes 94–118 and accompanying text (discussing pro rata sharing).

68. Jeffrey Davis, *Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy*, 41 FLA. L. REV. 1, 4 (1989) ("Constructive trusts and equitable liens are equitable remedies available to vindicate restitutionary claims.").

69. Beatty v. Guggenheim Exploration Co., 122 N.E. 378, 380 (N.Y. 1919), *superseded by statute as stated in* Israel v. Chabra, 906 N.E.2d 374, 378 (N.Y. 2009) (holding that oral consent to waive or amend a contract gives protection to the agent and acquits him of a breach of contract).

70. *See* RESTATEMENT (FIRST) OF RESTITUTION § 160 (1937) ("Where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it, a constructive trust arises.").

71. *See id.* § 161 ("Where property of one person can by a proceeding in equity be reached by another as security for a claim on the ground that otherwise the former would be unjustly enriched, an equitable lien arises.").

72. *See* Davis, *supra* note 68, at 4.

73. RESTATEMENT (FIRST) OF RESTITUTION § 202 (1937).

The remedies differ in that a constructive trust grants the plaintiff title to the asset while an equitable lien only places a lien upon the asset.[74] Though the remedies vary in some significant respects, courts recognize their similarities as equitable remedies,[75] and the precise differences are not important for this Note. For either remedy, to recover the asset, the claimant must prove a restitutionary right and identify his rightful property among the wrongdoer's holdings.[76] If the wrongdoer still holds the exact property that was wrongfully taken from the claimant, specific identification is easy and tracing is not necessary.[77] Instead, the claimant simply ascertains the current physical location of a tangible asset in a process most aptly described as "following."[78] However, this is rarely the case as the wrongdoer is likely to have converted the asset or otherwise disposed of it.[79]

Tracing is the substitution process[80] that allows the claimant "to follow his property through various forms and transactions and establish his equitable claim."[81] For example, the wrongdoer may have sold the misappropriated property for cash. Proceeds of the sale identifiable in the wrongdoer's bank account belong to the claimant; the change in form is immaterial.[82] In these direct tracing situations, "[t]he claimant . . . is effectively arguing that his ownership rights should be transferred to

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74. *See* Davis, *supra* note 68, at 4 ("The difference between them is that imposition of a constructive trust . . . gives the plaintiff title to the asset, whereas imposition of an equitable lien merely gives the plaintiff a lien on the asset.").

75. *See id.* at 17 n.65 ("Some courts do not bother to characterize the claim as one or the other, referring to the claim instead simply as an 'equitable right.'").

76. *See* Davis, *supra* note 68, at 4.

77. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (2011) ("[I]f A's claim is that B obtained X from A by fraud, and A seeks specific restitution of X via constructive trust, there is no need to 'trace' if A can still identify X in B's possession.").

78. SMITH, *supra* note 54, at 6; *see also* Robert Chambers, *Tracing and Unjust Enrichment*, *in* UNDERSTANDING UNJUST ENRICHMENT 263, 263 (Jason W. Neyers et al. eds., 2004) ("We follow assets, trace value, and claim rights.").

79. *See supra* notes 42–45 and accompanying text (explaining that misappropriated assets are exhausted for a number of reasons).

80. SMITH, *supra* note 54, at 6 ("[T]he context of tracing is substitution.").

81. Claire Seaton Rosa, Note, *Should Owners Have to Share? An Examination of Forced Sharing in the Name of Fairness in Recent Multiple Fraud Victim Cases*, 90 B.U. L. REV. 1331, 1338 (2010).

82. *See* George Gleason Bogert, George Taylor Bogert & Amy Morris Hess, BOGERT'S TRUSTS AND TRUSTEES § 921 (2010) ("It is a fundamental principle in the English common law that a change of form in a thing which is owned does not change the ownership.").

property that has been substituted for his property, or is the product of his property."[83] Simply put, "[t]racing is the process of tracking the location of value when one asset is exchanged for another."[84]

Presumptive tracing, also known as tracing fictions,[85] comes into play when "indistinguishable property is combined in an undifferentiated mass or fund (as when money belonging to two people is deposited in the same bank account)."[86] Because of the fungible nature of the property "it may be impossible to specify the ownership of any particular asset within the fund, or of an asset acquired with withdrawals from the fund, except by [tracing] rules designed to answer these questions."[87] In this scenario, all presumptions are drawn in favor of the innocent investor as against the wrongdoer. If the wrongdoer simply deposited the money in a personal bank account, the victim will recover the full amount.[88]

> *Illustration:*
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> Recipient wrongfully takes $100 belonging to Claimant and uses it to open an account with Bank. Recipient then deposits $200 of his own in the same account. There are no other transactions in the account. After Recipient's wrongdoing comes to light, Bank attempts to set off the $300 balance of the account against Recipient's unsecured debt to Bank. Claimant is entitled to payment of $100 from the account in priority to Bank.[89]

If the wrongdoer removed any money, it is presumed that the wrongdoer withdrew his own funds prior to the funds of the victim.[90]

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83. Rosa, *supra* note 81, at 1342.

84. Chambers, *supra* note 78, at 263.

85. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. b (2011) ("The rules for tracing through a commingled fund are often called 'tracing fictions' . . . .").

86. *Id.* cmt. a.

87. *Id.*; *see also* SMITH, *supra* note 54, at 1 ("[T]racing should be regulated by principles which make sense, and which are supported not just by reason of authority, but by the authority of reason. It should not be regulated by irrational fictions.").

88. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. c (2011) ("The traceable product of the claimant's assets is readily identifiable in the fund itself, or in property acquired with the whole of a commingled fund, if there are no intermediate transactions and (consequently) no need for a rule to determine whose money is being applied.").

89. *Id.* illus. 1.

90. *See id.* § 59(2)(a) ("If property of the claimant has been commingled by a recipient who is a conscious wrongdoer or a defaulting fiduciary (§ 51) or significantly at fault in dealing with the claimant's property (§ 52): (a) Withdrawals that yield a traceable product and withdrawals that are dissipated are marshaled so far as possible in favor of the

> *Illustration:*
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> Acting without authorization, Recipient deposits $1000 of Claimant's funds in a bank account that already contains $1000 of Recipient's funds. Recipient later withdraws $1500 from the account, using this money for current expenditures. Claimant is entitled to recover the $500 remaining in the account via constructive trust or equitable lien, and Claimant has an unsecured claim for the balance of the misappropriated funds.[91]

If there are multiple subsequent withdrawals and deposits, the victim's claim is limited to the lowest intermediate balance.[92]

> *Illustration:*
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> On July 1, acting without authorization, Recipient deposits $1000 of Claimant's funds in a bank account that already contains $1000 of Recipient's funds. Recipient files for bankruptcy on December 31; Claimant seeks restitution from the traceable product of his $1000 in Recipient's bankruptcy estate. Between July 1 and December 31, Recipient has made numerous withdrawals from the bank account and numerous deposits of his own funds; the final balance in the hands of the bankruptcy trustee is $3000. Because Claimant is unable to identify the product of any of the withdrawals, Claimant seeks to identify some portion of this $3000 as the product of his initial $1000. From July 1 to December 31, the balance of Recipient's account fluctuated between a high of $5000 and a low of $200. The bankruptcy trustee holds $200 of the account in constructive trust for Claimant, and Claimant has an unsecured claim in restitution for $800.[93]

Although tracing works when there are limited claimants, in Ponzi schemes, where the funds of many victims are comingled, individual tracing often becomes impossible.[94] This problem was recognized at common law, when multiple claimants could follow their asset into a

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claimant.").

91. *Id.* illus. 4.

92. *See id.* at § 59(2)(b)–(c) ("Subsequent contributions by the recipient do not restore property previously misappropriated from the claimant . . . . After one or more withdrawals from a commingled fund, the portion of the remainder that may be identified as the traceable product of the claimant's property may not exceed the fund's lowest intermediate balance.").

93. *Id.* illus. 10.

94. *See id.* § 59 (explaining that tracing rules are unequipped to deal with massive fraud); Thomas R. Cox, Robert J. Morad & Clarence L. Pozza, Jr., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113, 130 (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.").

mixture, but the exact items belonging to each were unidentifiable.[95] Because each claimant had a commensurate right to follow into the mixture, but the assets were insufficient to satisfy fully the claims and the claimants could not identify their specific assets, the rule became "where there has been a diminution of the mixture, the loss will be born by the contributors in proportion to their contribution."[96] Similarly, under Section 59 of the Restatement (Third) of Restitution & Unjust Enrichment, if "the court [cannot] distinguish the interests of multiple restitution claimants by reference to actual transactions, such claimants recover ratably from the fund and any product thereof in proportion to their respective losses."[97]

> *Illustration:*
>
> Charles Ponzi persuades thousands of victims to entrust their savings to him by issuing promissory notes, redeemable in 90 days at $150 for each $100 invested. Notes presented for payment are redeemed with the proceeds of the notes subsequently issued. During the eight-month life of the scheme, from December to August, Ponzi issues $15 million in promissory notes at an aggregate price of $10 million . . . . Ponzi has no income apart from the sale of the notes, and he is at all relevant times insolvent. Disclosure of the fraud on August 1 provokes a panic. At the close of business on this date Ponzi's bank balance . . . stands at $6 million. . . . Notes presented are redeemed at par until August 9, when Ponzi's account is overdrawn, leaving another $5 million in notes unpaid. Braving the crowds in the streets, certain fraud victims (the 'Diligent Creditors') manage to obtain payment of their notes on August 4, when the balance of Ponzi's account—although rapidly declining—remains positive. In the ensuing bankruptcy proceedings, Ponzi's Trustee seeks restitution of the payments made to Diligent Creditors on the grounds that they constituted an unlawful preference. . . . Instead, Diligent Creditors defend on the ground that they obtained payment on August 4 as a result of their own rescission for Ponzi's fraud (§§ 13, 54). On this reasoning they were not paid as creditors from Ponzi's assets: rather they reclaimed, identified, and retook their own money, which they identified by the tracing rules of § 59(2). The argument fails to recognize that the relevant dispute over priority is not between Diligent Creditors and Ponzi, but rather between Diligent Creditors and competing restitution claimants whose equitable position is identical to their own. The presumptions of § 59(2) do not serve to distinguish the

95. *See* SMITH, *supra* note 54, at 70–72 ("The principles are invoked whenever there is no practicable way to determine who contributed what.").

96. *Id.* at 73.

97. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 (2011).

> interests of the fraud victims inter se. Holders of notes outstanding on August 1 share ratably in Ponzi's closing balance on that date.[98]

In these situations, the individual victimized investors are pitted against one another—not against the erring fiduciary—to recover their investments. This is problematic because the Ponzi scheme operator, not the co-victims, acted wrongfully. Any remedy imposed should be against the wrongdoer.[99] However, the investors are competing over a limited fund that is insufficient to satisfy all their claims. In practice, the remedies essentially do run against other investors and tracing "has nothing to be said for it as a principle governing conflicting claims to restitution by equally wronged parties."[100]

In the first Ponzi scheme case, *Cunningham v. Brown*,[101] the Supreme Court held that because none of the claimants could directly trace their money, all the victims should share in the fund ratably, each in proportion to his own loss.[102] The *Cunningham* Court relied on its inherent equitable power to "disregard the rules of restitution and tracing to arrive at an 'equitable' answer"[103] that yielded a more just result.[104] *Cunningham* is credited with developing the concept that "equity is equality" when there are multiple similarly situated fraud victims,[105] and it is the paramount case cited when tracing is suspended.[106]

The Bankruptcy Code "was created for the express purpose of treating equally situated creditors equally."[107] Because "[a]ll investors in a Ponzi

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98. *Id.* illus. 23.

99. *See, e.g.*, DAN B. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION 27 (2d ed. 1993) ("[I]f the right is a right against A, then the remedy must not run against B. B may be unavoidably affected by what happens to A, but no remedy should run against B when B has violated no rights.").

100. Ruddle v. Moore, 411 F.2d 718, 719 (D.C. Cir. 1969) (concluding that pro rata distribution of the recovered commingled funds was proper).

101. *See* Cunningham v. Brown, 265 U.S. 1, 13 (1924) (finding that the claimants were of the same class and equity dictated pro rata distribution).

102. *Id.* at 11–13.

103. Saiman, *supra* note 49, at 1008.

104. *See* Doug Rendleman, *Irreparability Irreparably Damaged*, 90 MICH. L. REV. 1642, 1653 (1992) (reviewing DOUGLAS LAYCOCK, THE DEATH OF THE IRREPARABLE INJURY RULE (1991)) ("One of the ways the legal profession uses the word *equity* is to describe flexible and discretionary decisionmaking, crafting discrete solutions for particular problems when inflexible rules would create harsh results.").

105. *Cunningham*, 265 U.S. at 13.

106. A Westlaw query reveals that *Cunningham v. Brown* is cited in 208 subsequent cases as well as in hundreds of other briefs, memoranda, and supplemental sources.

107. Clemency & Goldberg, *supra* note 27, at 14; *see also* Cunningham v. Brown, 265

scheme are creditors of the same class . . . [that] in theory . . . should be treated equally,"[108] the Bankruptcy Code aims to attain equal treatment through avoidance. Avoidance of transfers received by earlier investors is premised on the belief that early investors are unfairly (though innocently) enriched at the expense of later investors.[109] The Ponzi scheme operator can only attract new investors so long as his scheme appears profitable, a feat which is accomplished by meeting payout demands of early investors. To meet the demands, the operator solicits new investments, and because the early investors achieve a return on investment, additional new investors are drawn into the scheme.[110] This circular pattern makes the earlier investors unwitting accomplices in continuing the fraud.[111] "[T]o allow any investor to recover promised returns in excess of the original amount invested would be to further the Debtor's fraudulent scheme at the expense of other investors, particularly newer investors."[112] From this perspective, pro rata distribution is appropriate because the returns given to the early redeemers are simply the principal investments of newly solicited investors.[113]

In order to increase the pool of funds to distribute pro rata, and in the interest of equity, the Bankruptcy Code allows the trustee to recapture, or

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U.S. 1, 13 (1924) ("[T]he principle that equality is equity . . . this is the spirit of the bankrupt law.").

108. Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 871 (D. Utah 1987).

109. *See infra* note 119 and accompanying text (explaining that most of the traceable assets are held by early redeemers, as payouts to early investors are necessary to perpetuate the scheme).

110. *See In re* Indep. Clearing House Co., 77 B.R. at 860.

> A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors.

Id.

111. *See In re* Taubman, 160 B.R. 964, 981 (Bankr. S.D. Ohio 1993) (authorizing the bifurcation of investors' claims against debtor into actual pecuniary losses and other claimed losses in order to treat claimants more equitably). The *Taubman* Court noted that "[a]n investor in a [P]onzi scheme is not only a victim but at the same time is a perpetrator." *Id.*

112. *Id.*

113. *See* S.E.C. v. Credit Bancorp, Ltd., 290 F.3d 80, 89 (2d Cir. 2002) (upholding the equitable authority of the District Court to authorize a pro rata distribution plan). As the court noted, "earlier investors' returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity." *Id.*

clawback,[114] money withdrawn by investors. Voiding transfers helps achieve parity between all investors. Underlying these clawback practices is the previously mentioned idea that all the victims should be treated similarly.[115] Essentially, "all [of] the victims of the same fraud are treated as a class and share pro rata in all the assets that any one of them can identify as (or trace to) his or her property."[116] Even when assets are specifically traceable to individual claimants, in situations where claimants are similarly situated, lower courts have gone so far as to order pro rata distribution[117] (however, it is important to note that the upcoming Restatement only supports pro rata distribution when individual tracing is impossible).[118]

Because many of the assets of a Ponzi scheme are paid out to earlier investors to keep the scheme operating, the payments received by earlier investors constitute a high percentage of the traceable assets.[119] In some cases, the sums paid out to earlier investors may be the only assets recoverable.[120] "[C]ourts have long held that is more equitable to attempt to

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114. *See* Cherry & Wong, *supra* note 44, at 370 ("The . . . term—'clawback'—has been used to refer to remedies potentially available to defrauded investors in a Ponzi scheme.").

115. *See supra* note 107 and accompanying text (noting that a major purpose of the Bankruptcy Code is to treat similarly-situated creditors in a similar manner).

116. Hanoch Dagan, *Restitution in Bankruptcy: Why All Involuntary Creditors Should Be Preferred*, 78 AM. BANKR. L.J. 247, 252 (2004).

117. *See, e.g.*, S.E.C. v. Forex Asset Mgmt. LLC, 242 F.3d 325, 331 (5th Cir. 2001) ("Although . . . tracing would have been permissible . . . the district court . . . did not abuse its discretion in . . . determining that it was more equitable to distribute the remaining . . . assets pro rata."); United States v. Durham, 86 F.3d 70, 73 (5th Cir. 1996) ("No one can dispute that tracing would have been permissible under the circumstances of this case. Claremont identified its funds . . . . The government in fact suggested that Claremont receive the traced funds. However, the court, in exercising its discretionary authority in equity, was not obliged to apply tracing." (citations omitted)); S.E.C. v. Elliott, 953 F.2d 1560, 1569–70 (11th Cir. 1992) ("We cannot say that the district court abused its discretion by disallowing tracing. A district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership."). For a critique of "forced sharing" and its place in restitution doctrine, see generally Rosa, *supra* note 81.

118. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 reporter's note (g) (2011) ("[T]he orthodox approach to multiple-fraud cases returns identifiable assets to their owners, turning to pro rata distribution only when specific identification or transactional tracing is impossible.").

119. *See Clawback Lawsuits on Rise in Aftermath of Ponzi Schemes*, DIMOND KAPLAN & ROTHSTEIN, P.A., http://www.dkrpa.com/Articles/Clawback-Lawsuits-on-Rise-in-Aftermath-of-Ponzi-Schemes.shtml (last visited Aug. 9, 2011) ("The majority of the money . . . is not expected to come from Madoff or the sale of his assets. Those who are expected to pay the lion's share of the losses are other victims—and those who benefited—from Madoff's Ponzi scheme.") (on file with the Washington and Lee Law Review).

120. *See* Barasch & Chesnut, *supra* note 64, at 924 ("In many cases, the only asset

distribute all recoverable assets among the defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fell."[121] The only meaningful way to reallocate losses in the context of a Ponzi scheme is often through avoidance of transfers to earlier investors. The panoply of tools available to the trustee to effectuate a more equitable distribution between early and late investors includes avoiding actual fraudulent transfers, constructive fraudulent transfers, and preferential transfers.[122]

IV. Avoidance Under the Bankruptcy Code

Under § 548 of the United States Bankruptcy Code, the trustee can avoid fraudulent conveyances based on actual fraud or constructive fraud that are made within the two years preceding the filing of the bankruptcy petition.[123] Section 544(b) of the Code allows the trustee to avoid fraudulent conveyances based on state law,[124] which often has the impact of lengthening the applicable statute of limitations or reachback period.[125] Pursuant to § 547, the trustee may avoid, as preferences, the full amount of transfers made within the ninety days prior to the filing of the bankruptcy petition.[126]

A. Actual Fraudulent Transfers

Fraudulent conveyance claims based on actual fraud, also referred to as fraud in fact,[127] are pursued under Bankruptcy Code § 548(a)(1)(A), which provides as follows:

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available to provide any payment to the many investors and other creditors are legal claims to recover sums paid out by the entity before the crash.").

121. Donell v. Kowell, 533 F.3d 762, 776 (9th Cir. 2008).

122. 11 U.S.C. §§ 547–48 (2010).

123. 11 U.S.C. § 548 (2010).

124. *See* 11 U.S.C. § 544(b) (2010) ("[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim . . . .").

125. *See infra* notes 131–32 and accompanying text (explaining that state law often lengthens these time periods).

126. 11 U.S.C. § 547 (2010).

127. *See* 37 C.J.S. *Fraudulent Conveyances* § 74 (2010) ("[A] transfer may be characterized as actual fraud, or as one fraudulent in fact if it was made with the intent to defraud creditors . . . ."); 37 C.J.S. *Fraud* § 3 (2010) ("Moral fraud, positive fraud, and fraud

> The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily (A) made such transfer or incurred such obligation 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 . . . .[128]

Under an actual fraud allegation, the full amount withdrawn by the investor is subject to clawback.[129] "A transfer that constitutes [actual fraud] may be avoided in its entirety—as to both invested principal and profits—whether or not the debtor received value in exchange for the transfer."[130] Many states substantially extend the two-year statute of limitation[131] or extend the lookback period.[132] Section 544(b) allows the trustee to avoid transfers that an actual unsecured creditor could avoid under state law.[133] Most states

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in fact are the same as actual fraud . . . .").

128. 11 U.S.C. § 548 (2010).

129. *Id.*

130. *In re* Bayou Grp., LLC, 439 B.R. 284, 304 (S.D.N.Y. 2010).

131. *See* 11 U.S.C. § 548 (2010) (detailing the two-year congressionally imposed statute of limitations). Under state law, the time frame for bringing suit can be extended. For example, New York law extends the two-year time period to six years. McKinney's CPLR § 213 (2004) (noting that for an action based upon fraud, "the time within which the action must be commenced shall be the greater of six years from the date the cause of action accrued or two years from the time the plaintiff . . . discovered the fraud, or could with reasonable diligence have discovered it").

132. *See* Young v. United States, 535 U.S. 43, 47 (2002) (explaining that the lookback period is a designated amount of time preceding the bankruptcy in which the transfers made are subject to avoidance). "The lookback period is a limitations period because it prescribes a period within which certain rights . . . may be enforced." *Id.* The Bankruptcy Code allows transfers made within two years preceding the filing to be attacked as fraudulent. 11 U.S.C. § 548 (2010). This period can be lengthened under state law. *See* Cherry & Wong, *supra* note 44, at 398 ("[T]he reachback time period for fraudulent transfer claims under most state laws (which are based on either the UFTA or UFCA) is four years."); Lara R. Sheikh, *Sections 548 and 550—Developments in the Law of Fraudulent Transfers and Recoveries*, 2010 ANN. SURV. OF BANKR. LAW 8 ("The two-year limitation in [section 548] is augmented by the operation of section 544(b), allowing the trustee to bootstrap into state fraudulent conveyance law, which in turn can offer a lookback period of four or more years."). California has a particularly long lookback period of seven years for actual fraudulent transfers. *See* Cramer & Pilmer, *supra* note 36, at 27 ("California law provides a seven-year statute of repose for intentionally fraudulent transfer claims." (citing Cal. Civ. Code § 3439.09(c))).

133. 11 U.S.C. § 544(b) (2010).

have adopted the Uniform Fraudulent Transfers Act (UFTA), which has a four-year lookback period, although some states continue to use the Uniform Fraudulent Conveyances Act (UFCA), which provides for a six-year lookback period.[134] Thus, the trustee is able to take advantage of longer time periods provided by state law. The investor does not need to intend to hinder, delay, or defraud. "Actual fraudulent conveyance claims under Section 548(a)(1)(A) turn on the intent of the debtor in making the transfer; the state of mind of the transferee is irrelevant."[135] Accordingly, any transfer made as the result of a Ponzi scheme is presumed to be fraudulent.[136] Despite this Ponzi scheme presumption, the investor may be able to retain at least some of the transferred funds under an affirmative good faith defense, which "is practically the only defense for investors who are sued by Ponzi scheme bankruptcy trustees."[137] Because all transfers made pursuant to Ponzi schemes are presumed fraudulent, the investor carries the burden of proof in establishing good faith. This defense is provided for in § 548(c) of the Bankruptcy Code:

> [A] transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.[138]

The former investor must affirmatively prove good faith in order to not be divested of his or her principal. Regardless of good faith, the investor will be forced to repay all fictitious profits withdrawn.

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134. Arthur J. Steinberg & John F. Isbell, *Protecting Redemptions in a Ponzi Scheme Case*, 241 N.Y. L.J. 9 (2009); U.F.T.A. § 4 (1984); U.F.C.A. § 7 (1918).

135. *In re* Bayou Grp., LLC, 439 B.R. at 304.

136. *See, e.g.*, Hayes v. Palm Seedlings Partners (*In re* Agricultural Research and Tech. Grp., Inc.), 916 F.2d 528, 535 (9th Cir. 1990) (finding that a debtor's actual intent can be inferred from the mere existence of a Ponzi scheme); Jobin v. Waukau (*In re* M&L Bus. Mach. Co.), 166 B.R. 723, 724 (Bankr. D. Colo. 1993) ("[I]n a Ponzi scheme the only inference a court can make is that the Debtor had the requisite intent to hinder, delay or defraud under § 548(a)(1)."), *aff'd*, 167 B.R. 219 (D. Colo. 1994).

137. Paul Sinclair & Brendan McPherson, *The Sad Tale of Fraudulent Transfers: Part III*, 29-3 AM. BANKR. INST. J. 1, at 41 (2010).

138. 11 U.S.C. § 548 (2010).

B. Constructive Fraudulent Transfers

A second theory under which the trustee may proceed is that of constructive fraud. Actual fraud and constructive fraud "are distinguished by the presence or absence of an intent to deceive."[139] Constructive fraud, also known as "fraud in law,"[140] is presumed from the circumstances of the transaction.[141] Despite the absence of specific intent to defraud, the transfer is construed as fraudulent due to its "detrimental effect upon public interests and public or private confidence."[142] Under the constructive fraud theory, the trustee may only recover the profits—any return above the investor's original outlay—unless the investor can affirmatively prove a lack of good faith.[143] Thus, the major difference between actual fraud and constructive fraud is the allocation of the burden of proof on the issue of good faith.[144] Section 548(a)(1)(B) of the Bankruptcy Code states:

> The trustee may avoid any transfer . . . that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily received less than a reasonably equivalent value in exchange for such transfer or obligation and was insolvent on

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139. 37 C.J.S. *Fraud* § 3 (2010).

140. *Id.* ("[L]egal fraud and fraud in law are merely other names for constructive fraud.").

141. *Id.* ("[A] fraud is legal or constructive where it is implied from the nature of the contract or transaction or from the relation of the parties.").

142. 37 AM. JUR. 2D *Fraud and Deceit* § 9 (2010).

143. *See* Donell v. Kowell, 533 F.3d 762, 780 (9th Cir. 2008) (holding that the receiver's recovery of profits from investors was not inequitable). As explained by *Donell*:

> In the context of a Ponzi scheme, whether the receiver seeks to recover from winning investors under the actual fraud or constructive fraud theories generally does not impact the amount of recovery from innocent investors. Under the actual fraud theory, the receiver may recover the entire amount paid to the winning investor, *including* amounts which could be considered 'return of principal.' However, there is a 'good faith' defense that permits an innocent winning investor to retain funds up to the amount of the initial outlay. Under the constructive fraud theory, the receiver may only recover 'profits' above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may *also* recover the amounts that could be considered return of principal.

Id. at 771.

144. *Id.* ("The Seventh Circuit has suggested that the only practical distinction between these theories of recovery is the allocation of burdens of proof.") (citing Scholes v. Lehmann, 56 F.3d 750, 756–57 (7th Cir. 1995)).

> the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation . . . .[145]

By definition, in a Ponzi scheme, the liabilities of the operator outweigh the assets, so the debtor's insolvency is easy to prove. "[C]ourts have held that a debtor operating a Ponzi scheme is deemed insolvent from its inception as a matter of law."[146] Moreover, any profits withdrawn by the investor in excess of his principal investment will by definition exceed the value he invested. "[A] debtor does not receive a reasonably equivalent value for any payments made to the winning investor that represent profits since such profits are regarded as having been gained through theft from losing investors."[147] Under a constructive fraud theory, the investor will be forced to remit all fictitious profits withdrawn and, if the trustee can prove a lack of good faith, the investor may also be required to forfeit his principal.

C. Preferential Transfers

A preferential transfer is simply a transfer made by the debtor, while the debtor was insolvent, within ninety days of bankruptcy, on account of a debt owed, and which allows the creditor to receive more than it would in bankruptcy.[148] Preferential transfers differ from fraudulent transfers as they can be avoided absent any intent to defraud, and even if equivalent value was given, so long as the transfer was more than the creditor would have otherwise received under a bankruptcy distribution. The purpose of the preferential transfer statute is to ensure that creditors receive equal portions of the available assets.[149] Section 547(b) of the Bankruptcy Code states:

> [T]he trustee may avoid any transfer of an interest of the debtor in property (1) to or for the benefit of a creditor; (2) for or on account of an

145. 11 U.S.C. § 548 (2010).

146. Cherry & Wong, *supra* note 44, at 402; *see also* Warfield v. Byron, 436 F.3d 551, 558 (5th Cir. 2006) ("[A] Ponzi scheme . . . is, as a matter of law, insolvent from its inception."); Guy v. Abdulla, 57 F.R.D. 14, 17 (N.D. Ohio 1972) ("In a Ponzi-type operation, it may be possible to establish that the bankrupt was insolvent from the very inception . . . ."); Cunningham v. Brown, 265 U.S. 1, 8 (1924) ("[Ponzi] was always insolvent, and became daily more so . . . .").

147. Cherry & Wong, *supra* note 44, at 401.

148. 11 U.S.C. § 547 (2010); *see also* BLACK'S LAW DICTIONARY (9th ed. 2009) (outlining the necessary components of a preferential transfer).

149. *See* Gill v. Winn (*In re* Perma Pac. Properties), 983 F.2d 964, 968 (10th Cir. 1992) ("It is the ultimate aim of the preference law in the Bankruptcy Code to insure that all creditors receive an equal distribution from the available assets of the debtor.").

> antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made . . . on or within 90 days before the date of the filing of the petition . . . [; and] (5) that enables such creditor to receive more than such creditor would receive if . . . the transfer had not been made . . . .[150]

In the context of a Ponzi scheme, these requirements are easily met. Because Ponzi schemes are always insolvent, any transfer within ninety days of bankruptcy would occur during insolvency.[151] Moreover, § 547(f) specifically provides that "[f]or the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."[152] The transfer would be in repayment of the earlier investment. Because the investor (creditor) would probably receive very little in a bankruptcy distribution, most transfers—even ones returning principal only—would presumably exceed the recovery amount typically received. Accordingly, the investor will be compelled to repay all funds received within the 90-day period.

V. Shortcomings of the Current Statutory Scheme

The current statutory scheme does not adequately address the transactional realities of Ponzi schemes. The shortcomings of the Bankruptcy Code, coupled with the almost unbridled discretion of the trustee, results in inequitable outcomes between similarly positioned investors.

A. Actual Fraud: Abrogation of the Good Faith Defense

When actual fraud is alleged, the creditor may be able to utilize the affirmative defense of good faith to retain the principal amount invested.[153] The good faith defense is provided for in § 548(c) of the Bankruptcy Code:

> [A] transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest

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150. 11 U.S.C. § 547 (2010).

151. Cherry & Wong, *supra* note 44, at 402 ("[C]ourts have held that a debtor operating a Ponzi scheme is deemed insolvent from its inception as a matter of law.").

152. 11 U.S.C. § 547(f) (2010).

153. *See In re* Bennett Funding Grp., Inc., 232 B.R. 565, 573 (Bankr. N.D.N.Y. 1999) ("[S]ection [548(c)] has been construed as an affirmative defense, all elements of which must be proven by the defendant-transferee.").

> transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.[154]

Because a good faith transferee may retain funds "to the extent" that value was given, the investor can retain the principal.[155] However, the definition of "good faith" has narrowed over the years,[156] which means that truly innocent investors, who are already victims of a financial fraud and did not receive the benefit of their bargain, are further penalized by having to repay principal.

Complicating the good faith analysis is the fact that the term "is not defined in the [Bankruptcy] Code."[157] Though "[t]here is no legislative history," commentators proffer that Congress would have ascribed the traditional interpretation to the requirement of good faith, which is a subjective standard.[158] Perhaps surprisingly, even the SEC envisions a subjective standard as the appropriate standard. One judge recently criticized the SEC's position stating: "In imposing this 'mens rea' requirement, the SEC . . . [has] effectively limited the Receiver's recovery of principal to those winning investors who shared [the wrongdoer's] criminal intent."[159] The modern interpretation of good faith as an objective standard diverges from the SEC's interpretation. Moreover, it is "at odds with decades of tradition interpreting fraudulent transfer law"[160] and it conflicts with the meaning ascribed to good faith under the Uniform Commercial Code (UCC), which was the major piece of commercial legislation in effect at the time the Bankruptcy Code was drafted.[161]

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154. 11 U.S.C. § 548 (2010).

155. *Id.*

156. *See* Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28-3 AM. BANKR. INST. J. 16, at 10 (2009) [hereinafter Sinclair (Part I)] ("[T]he 'modern trend' [is] evidenced by a series of bankruptcy decisions that sharply limit the good-faith defense.").

157. *Id.* at 79–80.

158. *Id.*

159. Cox, Morad & Pozza, *supra* note 94, at 119 (quoting S.E.C. v. Forte, Nos. 09-63, 09-64, 2009 U.S. Dist. LEXIS 116802, *13 (E.D. Pa. Dec. 15, 2009)).

160. Sinclair (Part I), *supra* note 156, at 77.

161. *See* Craig T. Lutterbein, *"Fraud and Deceit Abound" but Do the Bankruptcy Courts Really Believe Everyone Is Crooked: The* Bayou *Decision and the Narrowing of "Good Faith,"* 18 AM. BANKR. INST. L. REV. 405, 444 (2010) ("'Good faith' is a term used in many provisions of the UCC. The UCC standard for 'good faith' in nearly every one of its articles was subjective in 1978 when the Bankruptcy Code was enacted and in section 1-201 the 1978 UCC defined good faith as honesty in fact.").

Until recently, courts consistently applied a subjective standard. As detailed in the seminal case of *Tacoma Ass'n of Credit Men v. Lester*:[162]

> There have been numerous efforts to define the term good faith. These efforts, if viewed as a whole, seem to attribute three factors or indicia to good faith: (1) An honest belief in the propriety of the activities in question; (2) no intent to take unconscionable advantage of others; and (3) no intent to, or knowledge of the fact that the activities in question will, hinder, delay, or defraud others.[163]

Justice Souter, while a First Circuit judge, distinguished between fraudulent transfers and preferential transfers, concluding that a preferential transfer was not a fraudulent transfer.[164] In *Boston Trading Group, Inc. v. Burnazos*,[165] he noted that:

> [F]raudulent conveyance law does *not* seek to void transfers . . . known as a preference. Suppose a debtor owes *A* $10,000 and *B* $20,000. He has only $8000, which he uses to satisfy his debt to *A*. This conveyance may be unfair to *B*, but it is not a fraudulent conveyance because it satisfies a debt owed to a person who is, at least, a legitimate creditor. *B* must find a remedy in bankruptcy, or in some other, law. The 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.[166]

Preferences are subject to avoidance in bankruptcy proceedings,[167] but not as fraudulent transfers. A narrow reading of the good faith defense essentially "confuses the distinct goals of preference law and fraudulent transfer law."[168] The *Burnazos* court specifically noted that the receipt of a preferential transfer simply was not synonymous with a lack of good faith:

> Whatever good faith may mean . . . it does not ordinarily refer to the transferee's knowledge of the *source* of the debtor's monies which the

162. Tacoma Ass'n of Credit Men v. Lester, 433 P.2d 901, 905 (Wash. 1967) (holding that the appellant did not meet his burden of proving good faith and thus the transfers made were properly avoided as fraudulent).

163. *Id.* at 904.

164. Sinclair (Part 1), *supra* note 156, at 78 (noting the distinction between the two types of transfers).

165. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1510 (1st Cir. 1987) (holding that while the claims alleged were insufficient to support a cause of action for actual fraud, the case had to be remanded to consider constructive fraud).

166. *Id.* at 1508–09.

167. *See supra* Part IV.C (discussing the preferential transfer statute in the Bankruptcy Code).

168. Lutterbein, *supra* note 161, at 458.

> debtor obtained at the expense of other creditors. To find a lack of good faith where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a kind of preference—concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless.[169]

Conversely, the modern good faith standard is objective, not subjective, so actual good faith is irrelevant.[170] If the defendant knew or should have known that "the debtor's investment scheme was too good to be true, then . . . the trustee is entitled to recover all amounts the investor received from the debtor."[171] 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.[172] This view is also shared by some judges, who view the narrow reading as judicial activism:

> [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

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169. *Boston Trading Grp., Inc.*, 835 F.2d at 1512.

170. *See* Jobin v. Waukau (*In re* M&L Bus. Mach. Co.), 166 B.R. 723, 724 (Bankr. D. Colo. 1993) (adopting an objective standard for good faith by examining what the defendant "knew or should have known" rather than examining the defendant's actual, subjective knowledge).

171. McDermott, *supra* note 42, at 177.

172. *See* Cherry & Wong, *supra* note 44, 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.").

> statutes and have made policy decisions that should be made by Congress.[173]

Despite criticism, there has been an undeniable narrowing of the affirmative defense. *In re Bayou Group, LLC*[174] sets forth the modern approach to determining good faith after first noting that "[t]he lack of clarity in the cases [in defining good faith] undoubtedly reflects a tension between a policy of protecting creditors from fraudulent transfers, and a policy of promoting the ease and security of commercial transactions."[175] The *Bayou* district court went on to present a two-step test to determine good faith:

> 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.[176]

Under the two-prong analysis, it must first be ascertained what actions constitute "inquiry notice."[177] The *Bayou* bankruptcy court compiled

173. 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) (holding that a loan met the requirement of "reasonably equivalent value" within the meaning of the Bankruptcy Code's fraudulent transfer provision).

174. *See In re* Bayou Grp., LLC, 439 B.R. 284, 308 & 317 (S.D.N.Y. 2010) (holding that although a prima facie case of actual fraud was established, factual issues relating to the good faith defense precluded summary judgment).

175. *Id.* at 309 n.22. As explained by the district court in *In re Bayou Group*:

> The two-year fraudulent conveyance period itself reflects a compromise between competing values. Congress could have provided for recovery whenever an investor has received a transfer from an insolvent entity and has been paid with another investor's money . . . . It also could have set a longer period for recovery than two years. In recognition of the fact that concepts of fairness and equity must yield at some point to the competing values of insuring the "ease and security of commercial transactions," however, Congress cut off such claims after two years.

Id. at 339.

176. *Id.* at 310–12.

177. BLACK'S LAW DICTIONARY (9th ed. 2009) (defining inquiry notice as "[n]otice attributed to a person when the information would lead an ordinarily prudent person to investigate the matter further"). Inquiry notice is when the duty to conduct further

instances where other courts "held that inquiry notice . . . preclude[d] a finding of good faith, including inquiry notice of the: fraudulent purpose of the transfer; underlying fraud; unfavorable financial condition for the transferor; insolvency of the transferor; improper nature of the transaction; [and] voidability of the transfer."[178] However, the court noted that these factors were not dispositive, and questions of good faith must be decided on a case-by-case basis.[179] Although the factors constituting inquiry notice are quite broad, the district court reversed an even more expansive interpretation approved by the bankruptcy court.[180]

In regards to the "diligent investigation" requirement, the *Bayou* bankruptcy court embraced a high standard:

> "[D]iligent investigation" must ameliorate the issues that placed the transferee on inquiry notice in the first place. In other words, if the diligent investigation aggravates, rather than allays, the concerns placing the transferee on inquiry notice, then no "good faith" defense is supported. Moreover, a transferee cannot satisfy the "diligent investigation" prong of the good faith test merely by inquiring with the transferor itself, even were the transferor to provide a plausible explanation of the issues. . . . [A] "diligent investigation" requires more than merely asking the transferor about the suspicious circumstances. In other words, a transferee cannot put his head in the sand in the face of unusual or suspicious circumstances and then take advantage of the "good faith" defense afforded by section 548(c). . . . [O]nce on inquiry notice, "taking no steps at all would . . . amount[] to 'willful ignorance,' which would . . . defeat[] the good faith defense."[181]

In theory, "[a]n objective, reasonable investor standard applies to both the inquiry notice and the diligent investigation components of the good faith test."[182] Despite the intended uniform application, in practice, courts hold

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investigation is triggered. *Id.*

178. *In re* Bayou Grp., LLC, 396 B.R. 810, 845–46 (Bankr. S.D.N.Y. 2008) *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010) (denying the investors' good faith defenses and granting summary judgment).

179. *Id.* at 846.

180. *See In re* Bayou Grp., LLC, 439 B.R. 284, 290 (S.D.N.Y. 2010) ("[T]he Bankruptcy Court broadly held that information suggesting some potential infirmity in the investment or some infirmity in the integrity of its management is a sufficient trigger. The Bankruptcy Court's expansion of the scope of information sufficient to trigger inquiry notice is not supported by . . . case law and requires reversal . . . .").

181. *In re* Bayou Grp., LLC, 396 B.R. 810, 846–47 (Bankr. S.D.N.Y. 2008) *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010) (citations omitted).

182. *In re* Bayou Grp., LLC, 439 B.R. 284, 313 (S.D.N.Y. 2010).

educated parties to a higher standard of due diligence.[183] Accordingly, "courts have generally been willing to find that knowledgeable investors did not act in objective good faith if their investment program showed significant signs of irregularity."[184] For example, in one of the rare cases where the court did not grant summary judgment against the defendants on the matter of good faith, it specifically noted the defendants' lack of sophistication, their smaller investments, and their less-prestigious jobs.[185] Institutional investors are also held to a more rigorous standard as they are presumably more sophisticated and have more resources to investigate, adding yet another standard of "reasonable" to the determination of good faith.[186]

Also problematic with the good faith defense is that savvy investors are presumably held to a higher standard than governmental monitoring agencies.[187] The SEC was informed of the fraudulent nature of Madoff's firm yet never uncovered the massive fraud.[188] If the SEC was unable to

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183. *See id.* ("Some courts have held that the standard . . . requires a specific focus on the class or category of the transferee. . . . [W]hether a transferee is on inquiry notice is informed by the standards, norms, practices, sophistication, and experience generally possessed by participants in the transferee's industry or class.").

184. McDermott, *supra* note 42, at 179.

185. *See* Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 862 n.29 (D. Utah 1987) (denying summary judgment). The court stated:

> The record shows certain facts from which the bankruptcy court might have drawn an inference that the defendants took in good faith. . . . [The] court may . . . have concluded that the undertakers generally were unsophisticated in investment matters, from the modest amounts some of the defendants advanced, by the jobs some held (as reflected in their answers to interrogatories) and by the fact that many of the defendants appeared pro se, suggesting either that they could not afford a lawyer or did not realize the need for one.

Id.

186. *See* Jeff F. Freidman & Anthony L. Paccione, *Clawback of Fraudulent Transfers from Investors—"Good Faith" Defense Update*, LEXOLOGY (Sept. 30, 2010), http://www.lexology.com/library/detail.aspx?g=218b746c-3690-4378-a4f6-c0bfe02d3bf1 (last visited Aug. 9, 2011) (noting that the *Bayou* district court "found that the nature of the transferee mattered in the good faith defense") (on file with the Washington and Lee Law Review).

187. *See Untangling Madoff's "Winners" And Losers*, NPR (July 27, 2010), https://www.npr.org/templates/story/story.php?storyId=128802589 ("[I]t [is] hard to believe that institutional investors and so-called feeder funds didn't see the red flags raised by Madoff's claims.") (on file with the Washington and Lee Law Review).

188. *See* Ralph A. Midkiff, *Recovering Losses When Schemes Are Exposed*, 2009 ASPATORE SPECIAL REP. 4 ("The SEC had been tipped that [Madoff's firm] was a Ponzi scheme, yet did little or no serious investigation to verify . . . . The SEC did not take the charges seriously, and never issued formal subpoenas to Madoff for his books and records.").

catch schemes like Madoff's, despite receiving tips on its probable fraudulent nature[189] and conducting at least five investigations over nearly two decades,[190] individual investors with substantially fewer resources and more limited access to financial data should not be charged with having a reason to suspect the integrity of the investment necessitating further investigation. If anything, an SEC investigation revealing no evidence of fraud should have relieved any investor concerns. The SEC also failed to vet Madoff when he registered as an investment advisor in 2006.[191]

Moreover, the "red flags" obvious with hindsight might not have been sufficient to put the investor on notice. Indeed, the appearance of legitimacy is what makes Ponzi schemes so damaging.[192] For example, the consistency of Madoff's returns was remarkable, but the percentage of returns was not necessarily unparalleled in the market.[193] Madoff's investment strategy also seemed plausible.[194] The split-strike conversion strategy[195] he claimed to employ does minimize downside risk and tends to lead to more consistent, if less lucrative, returns on investment.[196] The

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189. *See id.* (discussing the failure of the SEC to uncover Madoff's scheme despite receiving tips on its fraudulent nature).

190. *See* Debra Cassens Weiss, *SEC Lawyer Warned About Madoff in 2004*, A.B.A. J. (July 2, 2009, 7:06 AM), http://www.abajournal.com/news/article/sec_lawyer_warned_about_madoff_in_2004/ (last visited on Aug. 9, 2011) ("The SEC investigated Madoff's firms at least five times over nearly 20 years, including in 2007 after rival Harry Markopolos complained that Madoff's improbable returns were likely the result of a Ponzi scheme . . . .") (on file with the Washington and Lee Law Review).

191. *See* Campos, *supra* note 12, at 593 ("Traditionally, when an investment adviser registers with the Agency, the Office of Compliance, Inspections, and Examinations scrutinizes and examines the investor—in this case the SEC did not.").

192. *See* S.E.C. v. Forte, CIV.09-63, 2009 WL 4809804, *1 (E.D. Pa. Dec. 15, 2009) ("Ponzi schemes are pernicious because they masquerade as legitimate investments.").

193. *See* Efrati, Lauricella & Searcey, *supra* note 2 (noting that one fund averaged a 10.5% annual return).

194. *See* Gradwohl & Corbett, *supra* note 4, at 217 ("The successful schemes make the tale told by the perpetrator appear reasonable.").

195. *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 (explaining the split-strike conversion strategy and outlining its three main parts). "Part I is a . . . grouping of stocks that you purchase. . . . Part II consists of the call options that you are selling to generate income. Part III consists of the put options that you will be buying to protect your stock portfolio from market price declines . . . ." *Id.*

196. *See* Carole Bernard & Phelim P. Boyle, *Mr. Madoff's Amazing Returns: An Analysis of the Split-Strike Conversion Strategy*, 17 J. DERIVATIVES 62, *2 (2009), *available at* SSRN: http://ssrn.com/abstract=1371320 ("This strategy involves taking a long position in

complex transactions generate confusion even among trained market professionals.[197] Judge Richard Posner of the Seventh Circuit opined that Madoff's scheme did not have the hallmarks of a typical Ponzi scheme:

> 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).[198]

An 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."

B. Preferential Transfers: Reallocation of an Arbitrary Line

In practice, by voiding the "preference" of investors who withdraw money within three months (90 days) of bankruptcy, investors who fall outside the three-month statute of limitations receive preferential treatment.[199] In *In re Independent Clearing House Co.*,[200] the court explained that § 547 simply reallocates where the arbitrary line is drawn:

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equities together with a short call and a long put on an equity index to lower the volatility of the position.").

197. *See Hearings*, *supra* note 195, at 7 (testimony of Harry Markopolos) ("[T]he strategy is complex enough . . . that even market professionals without derivatives experience would have trouble keeping track . . . and understanding . . . fully.").

198. *See* 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) ("Madoff's scheme . . . is not a classic Ponzi scheme.") (on file with the Washington and Lee Law Review).

199. *See In re* Indep. Clearing House Co., 77 B.R. 843, 871 (D. Utah 1987) (explaining that the application of § 547 is limited and the transfers that cannot be reached are thus treated more favorable).

200. *Id.* at 875 (holding in part that the trustee was not entitled to a judgment as a matter of law on the preferential transfer claims).

> 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.[201]

The preferential transfer statute applies to a small fraction of transfers in the context of a multiple decade fraud. Investors who redeemed prior to the 90-day period are simply outside its scope. Because earlier investors are likely the ones that received substantial fictitious profits, the preferential transfer statue does little to redistribute assets. Its limited scope is likely why courts have read the fraudulent transfer statutes so broadly[202] and, as discussed in this Note, it unfairly penalizes investors who act in actual good faith.[203]

C. Trustee Discretion: Increased Uncertainty and Prolonged Litigation

The trustee is given great discretion in deciding which clawback claims to pursue,[204] which injects a subjective element into the application of the law and is likely to lead to prolonged litigation.[205] For example, the

201. *Id.* at 871 (citations omitted).

202. *See supra* notes 172–73 and accompanying text (explaining that the abrogation of the good faith defense treats fraudulent transfers like preferential transfers).

203. *See* Part V.A (discussing the consequences of the narrowing good faith defense).

204. *See* Barasch & Chestnut, *supra* note 64, at 926 ("The trustee or receiver in a Ponzi scheme has a fair amount of discretion in whether to pursue claims against investors and other transferees.").

205. *See* Alain Leibman, *Revisiting Madoff and His Stakeholders—Is Trustee Picard Pursuing Hadassah and Other Charities as Candidates for "Clawback"?—Installment 32*, WHITE COLLAR DEFENSE AND COMPLIANCE, Fox Rothschild LLP (Aug. 2, 2010), http://whitecollarcrime.foxrothschild.com/2010/08/articles/bernard-madoff/revisiting-

trustee in Madoff's bankruptcy, Irving Picard, has said that he will not seek the return of funds from "net losers,"[206] and he will not file lawsuits against "net winners"[207] who are financially destitute. He "recognizes that many people are not going to be in a position to pay anything back."[208] As a result, a hardship program has been implemented.[209] Picard assesses whether investors, who would otherwise be subject to avoidance actions, qualify for hardship based on factors including inability to pay for necessary living expenses (including loss of home to foreclosure), necessary medical expenses, or the care of dependents.[210] "Declaring personal bankruptcy . . . [or o]therwise suffering from extreme financial hardship as demonstrated by other circumstances" are also grounds for hardship exception.[211] Although it seems patently unfair to force those with limited means to pay back funds, it essentially means that wealthy investors are the only parties targeted, simply because they are in a position to pay. Prudent investors who saved the money that they withdrew can "afford" to return those funds and are forced to do so, while those who spent the money lavishly can claim hardship. This promotes irresponsible spending over saving and disfavors generally wealthier investors with the financial stability to return what they withdrew. Although there is some sense of fairness in the notion of only forcing those to pay who are able to do so, the law should at least attempt to treat all parties similarly, and an exception that promotes poor financial management should be against public policy.

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madoff-and-his-stakeholders-is-trustee-picard-pursuing-hadassah-and-other-charities-as-candidates-for-clawback-installment-32/#page=1 (last visited Aug. 9, 2011) ("[T]he criteria that Mr. Picard will use to separate those from whom he will seek clawback and those . . . from whom he will not raise fundamental questions of fairness, size[,] and relative value that will likely lead to much more controversy and potential litigation.") (on file with the Washington and Lee Law Review).

206. *See Assessing the Limitations of the Securities Investor Protection Act: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. 1 (2010) (testimony of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School), *available at* http://financialservices.house.gov/Media/file/hearings/111/Coffee092310.pdf (defining net losers as investors who withdrew less than the amount of their principal).

207. *See id.* (explaining that net winners are investors who withdrew their principal and any fictitious profits).

208. *Untangling Madoff's "Winners" And Losers*, *supra* note 187.

209. *See* Bernard L. Madoff Investment Securities LLC Liquidation Proceeding, *Hardship Program*, http://www.madofftrustee.com/HardshipProgram.aspx (last visited Aug. 9, 2011) (outlining the hardship program) (on file with the Washington and Lee Law Review).

210. *Id.*

211. *Id.*

Instead of filing lawsuits against all people who withdrew more than their principal, Picard's lawsuits are being filed primarily against those who he deems "should have known," which incidentally coincides with deeper pockets.[212] This sentiment of perceived unfairness is well-reflected by the statements of Fred Wilpon and Saul Katz, owners of the New York Mets, who were recently sued for $1 billion,[213] $300 million of which reflects profits and $700 million of which is principal withdrawn over the years.[214] The men allege that the claims against them are "abusive, unfair[,] and untrue," and that the lawsuit is nothing more than "an outrageous strong-arm effort to try to force a settlement by threatening to ruin our reputations and businesses."[215] "[T]he lawsuit seeks to hold them responsible for the indirect benefits they derived from the apparent success of their many investments in Mr. Madoff's firm, which allowed them to flourish in other areas, including buying the Mets."[216] In the words of one Wall Street Journal columnist:

> The Wilpon-Katzes are accused of taking out $300 million in "fictitious profits," but the family is also worth much more than that, which makes them irresistible targets for the fatal "or"—they knew *or should have known* that Madoff was a fraud. Hence the Picard lawsuit's demand of an additional $700 million in principal the family had withdrawn over the years.[217]

Picard's aggressive stance towards the Mets' owners must be contrasted with his approach toward some charities. Cognizant that many charities "are struggling with materially reduced contributions because of the economy, increased demands by individuals who are unemployed and suffering financially, losses in endowment funds from the substantial

212. *Untangling Madoff's "Winners" And Losers*, *supra* note 187.

213. 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) (on file with the Washington and Lee Law Review).

214. 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/SB10001424052748704364004576132201926195130.html (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

215. Voris, *supra* note 213.

216. Peter J. Henning, *Mets Owners Face Novel Claim in Madoff Clawback*, N.Y. TIMES (DEALBOOK) (Feb. 7, 2011, 2:49 PM), http://dealbook.nytimes.com/2011/02/07/mets-owners-face-novel-claim-in-madoff-clawback/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

217. Jenkins, *supra* note 214.

market declines and increased regulatory activity," he has taken a less aggressive approach towards such organizations.[218] For example, Hadassah, a Jewish charitable organization, was allowed to voluntarily settle by repaying $45 million, even though it faced a potential clawback claim, for fictional profits alone, of $97 million.[219] This is approximately a mere 58% of the fictitious profits.[220] It is worth noting that "Hadassah had sophisticated investment advisers over the period of their Madoff investments," so the disparity in treatment cannot be based on level of financial acumen.[221] "While the [more lenient] position . . . by Picard as to charities may be humanitarian and emotionally appealing, there is little basis in the law for the disparity in treatment between charities and for-profit entities."[222] By evaluating the relative worth of investors, and subjectively determining the amount for which the party should be held accountable, Picard exacerbates the uncertainty in terms of prospective liability and makes investors more likely to feel they were treated unfairly and seek judicial review.[223]

Predictably, the suggestion that Picard's disparate treatment will lead to litigation has already proven true.[224] Wilpon and Katz succeeded in having the lawsuit against them moved from federal bankruptcy court to

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218. Alain Leibman, *The Madoff Profit Game: Will the Mets End up Losers Off the Field While Charity Stakeholders Become Winners?—Installment 17*, WHITE COLLAR DEFENSE AND COMPLIANCE, Fox Rothschild LLP (Oct. 26, 2009), http://whitecollarcrime.foxrothschild.com/2009/10/articles/bernard-madoff/the-madoff-profit-game-will-the-mets-end-up-losers-off-the-field-while-charity-stakeholders-become-winners-installment-17/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

219. Alain Leibman, *Picard Chases Madoff "Winners" in Inconsistent Fashion—Contrasting Treatment of the Wilpon Family Versus Hadassah—Installment 45*, LEXOLOGY (Feb. 9, 2011), http://www.lexology.com/library/detail.aspx?g=7201f843-bf8b-4d32-9778-229177a03431 (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

220. Michael J. Kline, *Picard Crusades Against the Wilpon/Katz Family Charitable Foundations While He Moves to Settle with Hadassah*, LEXOLOGY (Feb. 21, 2011), http://www.lexology.com/library/detail.aspx?g=4d9400eb-8be7-46a8-8a44-461456cd12ec (last visited Aug. 9, 2011) ("Picard is willing to settle for approximately 58% of the Fictitious Profits reported for Hadassah, presumably because they may be a worthier charitable vehicle in his eyes than the [charities of Wilpon and Katz].") (on file with the Washington and Lee Law Review).

221. Leibman, *Picard Chases Madoff "Winners" in Inconsistent Fashion*, *supra* note 219.

222. *Id.*

223. *See id.* ("This inequality of approach will more likely than not lead to protracted litigation and uncertainty in the Madoff matter.").

224. *See, e.g.*, Picard v. Katz, 11-cv-03605, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011).

district court.[225] On September 27, 2011, U.S. District Judge Jed Rakoff dismissed nine of the eleven claims against the Mets owners.[226] Rakoff found that Picard could only maintain claims under federal bankruptcy law and could not take advantage of the longer time period provided under state law.[227] The main claim remaining alleges actual fraud under Bankruptcy Code § 548(a)(1)(a).[228] This limits the financial exposure of Wilpon and Katz to withdrawals made within two years of the bankruptcy filing by Madoff's firm.[229] Judge Rakoff noted that Picard could not recover withdrawals of principal made within the two years preceding the filing of the bankruptcy petition under § 548(c) "absent bad faith."[230] Significantly, Rakoff rejected the "inquiry notice" approach taken by the *Bayou* court in determining "good faith" under § 548(c).[231] Instead, in the "context of a SIPA trusteeship," Rakoff found that scienter was required to prove a lack of good faith: Only "'willful blindness' to the truth is tantamount to a lack of good faith."[232] Rakoff elaborates:

> The difference between the inquiry notice approach and the willful blindness approach is essentially the difference between an objective standard and a subjective standard. . . .
>
> A securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty. If an investor, nonetheless, intentionally chooses to blind himself to the "red flags" that suggest a high probability of fraud, his "willful blindness" to the truth is tantamount to a lack of good faith. But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices—and how could he do so anyway?—his lack of due diligence cannot be equated with a lack of good faith, at least so

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225. Richard Sandomir, *Ruling Limits Financial Exposure of Mets' Owners*, N.Y. TIMES, Sept. 28, 2011, at B11, *available at* http://www.nytimes.com/2011/09/28/sports/baseball/parts-of-suit-against-mets-owners-are-dismissed.html.

226. Picard v. Katz, 2011 WL 4448638, at *3 ("[T]he Court grants the defendants' motion to dismiss all claims predicated on principles of preference or constructive fraud under the Bankruptcy Code.").

227. *Id.* at *2–3. This decision was based on the "safe harbor" in Bankruptcy Code § 546(e), which limits fraudulent conveyance claims to two years when it involves a "settlement payment" that is "made by or to (or for the benefit of) a . . . stockbroker, in connection with a securities contract." *Id.* at *2; *see also* 11 U.S.C. § 546(e) (2006).

228. *Id.* at *3.

229. *Id.* at *4–5.

230. *Id.* at *3.

231. *Id.* at *5.

232. *Id.*

> far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.[233]

However, Rakoff's ruling is tempered by a footnote in which he states: "[T]he Court does not resolve on this motion whether the Trustee can avoid as profits only what defendants received in excess of their investment during the two year look back period specified by Section 548 or instead the excess they received over the course of their investment with Madoff."[234] While the decision purports to clarify the bounds of Picard's reach, it does not provide the clarity necessary to facilitate out of court settlements. Additionally, Picard has already filed an appeal.[235]

In the Madoff liquidation, mediation is mandatory for all parties against whom an avoidance action is brought.[236] If Picard seeks $20 million or less, he will pay for the mediation expenses, but for all claims over $20 million, the expense falls on the investor.[237] If individual investors disagree with Picard's assessment, the investor does have the option to proceed to court instead of settling with the trustee. However, in the words of Steve Harbeck, the president of SIPC, Picard "has the resources to conduct a serious and intense legal campaign."[238] The investor must also keep in mind that the trustee is appointed by the presiding judge. "As a result, you'll get a fair hearing, but it will be subjectively biased in favor of the trustee [and m]ost bankruptcy judges tend to be as pro-trustee as federal judges tend to be pro-prosecutor . . . ."[239] Moreover, the party

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233. *Id.*

234. *Id.* at *4 n.6.

235. *See* Bernard L. Madoff Investment Securities LLC Liquidation Proceeding, *Court Filings*, http://www.madoff.com/CourtFilings.aspx (last visited Oct. 15, 2011) (on file with the Washington and Lee Law Review). On October 7, 2011, Picard filed a Memorandum of Law in which he seeks an interlocutory appeal. *Id.*

236. *See* Howard R. Elisofon & Steven D. Feldman, *Bankruptcy Judge Approves Procedures to Facilitate Claw Back Litigation Against Madoff Investors*, LEXOLOGY (Nov. 24, 2010), http://www.lexology.com/library/detail.aspx?g=16b4c512-cc52-4130-9387-a9cf28d08300 (last visited Aug. 9, 2011) (noting that under the court-approved procedures, "[a]ll actions will be referred to mandatory mediation") (on file with the Washington and Lee Law Review).

237. *Id.*

238. Floyd Norris, *A Blank Check for Cleaning Up Madoff's Mess*, N.Y. TIMES, Feb. 25, 2011, at B1, *available at* http://www.nytimes.com/2011/02/25/business/25norris.html.

239. Ken Belson, *For Mets' Owners, Court Fight Could Be Costly*, N.Y. TIMES, Feb. 8, 2011, at B10, *available at* http://www.nytimes.com/2011/02/08/sports/baseball/08picard-mets.html.

must cover its own litigation costs, which can be substantial.[240] The party would also have its finances publicly vetted.[241]

In terms of recapturing the greatest amount of assets from the fewest number of individuals, an approach of targeting wealthier individuals makes sense. However, it unfairly penalizes wealthier parties, who are forced to pay back considerably more than just the "fictitious profits" withdrawn during the reachback period in order to avoid a costly and reputation-damaging trial.[242] Even the SEC has "argued that it would be inequitable to pursue disgorgement of principal payments from a select few investors when there are hundreds—maybe even thousands—of investors who have received principal payments yet are not being sued or are beyond the court's jurisdiction."[243]

Picard's largest settlement of $7.2 billion, which notably is "the largest single forfeiture in American judicial history," came from the estate of Jeffery Picower.[244] His estate agreed to repay not just the $2.4 billion withdrawn within the six-year reachback period, but the entire $7.2 billion withdrawn by "Picower, his charitable foundation[,] and related entities . . . over 20 years."[245] This decision was presumably made to avoid a lifetime of litigation.[246]

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240. *See id.* ("In addition to the emotional and physical cost of going to trial, Wilpon and Katz would probably face legal bills of about $1 million a month, given the number of complaints and entities involved.").

241. *See id.* ("[T]here is the likelihood that every corner of their financial lives would be publicly explored.").

242. *See* Joshua Gallu, David Voreacos & Bob Van Voris, *Picower Estate Said to Pay $7.2 Billion in Biggest Madoff Fraud Settlement*, BLOOMBERG (Dec. 17, 2010, 10:33 AM), http://www.bloomberg.com/news/2010-12-17/picower-estate-said-to-pay-7-2-billion-in-biggest-madoff-fraud-settlement.html (last visited Aug. 9, 2011) (noting that the Picower settlement required the estate to pay back all the profits ever received, a time frame which spanned over two decades) (on file with the Washington and Lee Law Review).

243. Cox, Morad & Pozza *supra* note 94, at 121 (citing Brief of Securities and Exchange Commission, Amicus Curiae, in Support of Appellees, at 11–12, Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009) (No. 09-10761)), *available at* http://www.stanfordfinancialreceivership.com/documents/SEC_Amicus_brief.pdf.

244. Diana B. Henriques, *Deal Recovers $7.2 Billion for Madoff Fraud Victims*, N.Y. TIMES (DEALBOOK) (Dec. 17, 2010, 9:51 AM), http://dealbook.nytimes.com/2010/12/17/big-settlement-with-madoff-investor-near/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

245. Gallu, Voreacos & Van Voris, *supra* note 242.

246. *See* Diana B. Henriques, *Madoff Investor Said to Have Drowned*, N.Y. TIMES, Oct. 27, 2009, at B1, *available at* http://www.nytimes.com/2009/10/27/business/27madoff.html (noting that the Picower's have found the litigation to be "emotionally and physically" upsetting).

Picard has also taken advantage of the possibility of treble damages or putative damages. Picard has filed a lawsuit against JPMorgan Chase seeking approximately $1 billion in bank profits and an additional $5.4 billion in damages.[247] He is also seeking $9 billion from HSBC, a London-based financial institution,[248] and $2 billion from USB AG, a Swiss bank.[249] He has "sued Bank Medici AG and its founder, Sonja Kohn, as well as Bank Austria, UniCredit SpA and [additional] parties . . . seeking $19.6 billion from them, which could triple to $58.8 billion under the Racketeer Influenced and Corrupt Organizations Act (RICO)."[250] Given the substantial claims already filed against financial institutions,[251] even Madoff has commented that Picard is pursuing individual investors too aggressively.[252] While some of Picard's claims have been dismissed for lack of standing he has filed a notice of appeal.[253]

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247. Martha Neil, *Madoff Trustee Sues JPMorgan Chase, Seeks $6B for Alleged Blind Eye to Massive Swindle*, A.B.A. J. (Dec. 2, 2010, 3:31 PM), http://www.abajournal.com/news/article/madoff_trustee_sues_j.p._morgan_chase_seeks_6b_for_claimed_aid_to_massive_s/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

248. Diana B. Henriques, *Madoff Suit Cites HSBC as a Helper*, N.Y. TIMES, Dec. 6, 2010, at B1, *available at* http://www.nytimes.com/2010/12/06/business/06madoff.html?adxnnl=1&hpw=&adxnnlx=1291637114-YRNcApCkYWOOTpOSUkE0SQ#.

249. Ashby Jones, *Picard Goes Big, Sues UBS for $2 Billion in Madoff Case*, WALL ST. J. L. BLOG (Nov. 24, 2010, 8:19 AM), http://blogs.wsj.com/law/2010/11/24/picard-goes-big-sues-ubs-for-2-billion-in-madoff-case/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

250. Gallu, Voreacos & Van Voris, *supra* note 242.

251. *See* Norris, *supra* note 238, at B1 ("It now appears that . . . [investors] might . . . get it all back, particularly if the banks agree to substantial settlements. If that happened, it is possible that the net winners, who were victims of a fraud since they were told they had money that did not exist, might also get some money.").

252. *See* Diana B. Henriques, *From Prison, Madoff Says Banks "Had to Know" of Fraud*, N.Y. TIMES, Feb.16, 2011, at B1, *available at* http://www.nytimes.com/2011/02/16/business/madoff-prison-interview.html?pagewanted=1&hp.

> [Madoff was] critical of the trustee's reach, claiming that . . . Picard was seeking far more money than was needed to resolve valid investor claims. . . . Madoff calculated that the lawsuits against major banks and hedge funds would produce more than enough to cover the rest of the cash losses without . . . Picard having to pursue "clawback" litigation . . . .

Id.

253. *See, e.g.*, Linda Sandler, *Madoff Trustee Appeals $9 Billion Ruling in HBSC Case*, BLOOMBERG (Aug. 30, 2011 10:17 AM), http://www.bloomberg.com/news/2011-08-30/madoff-trustee-picard-appeals-judge-s-ruling-in-hsbc-case.html (last visited Oct. 9, 2011) (noting Picard's appeal in the HSBC case) (on file with the Washington and Lee Law Review).

However, some bankruptcy trustees are even more aggressive than Picard. Doug Kelley, the trustee who is overseeing the bankruptcy of convicted Ponzi schemer Thomas Petters, has asserted that the reachback period applicable to clawbacks is "suspended by reason of the schemer's concealment of the fraudulent Ponzi scheme."[254] This would allow Kelley to recoup not only the profits and principal withdrawn in the last six years, but every withdrawal ever made since the inception of the Ponzi scheme.[255] He has stated that he will "reach back for money from the start of the Ponzi scheme, more than a decade ago."[256] Although Kelley's theory of concealment remains untested in the courts,[257] it evidences the lack of predictability facing investors. In Kelley's own words, "[w]e are making law day by day."[258] The bankruptcy judge handling the *Petters* case has reserved ruling on the statute of limitations issue.[259] Because investors are unable to calculate how much they may be liable for, it will presumably make mediation less successful, or force them to settle because they fear the aggressive stance that the trustee will pursue in court and cannot predict the court's ruling due to the lack of coherent case law.

VI. Proposed Solutions to Promote Predictability in Asset Distribution Post-Bankruptcy

Given the broad discretion afforded to bankruptcy trustees in pursuing clawback claims selectively and the wide latitude of the bankruptcy or district court to craft remedies as it deems fit, the asset distribution plan in

254. Sidney Goldstein, *The Search For A "Deep Pocket" in a Period of Economic Uncertainty*, LEXISNEXIS, 2011 Emerging Issues 5478 (Jan. 11, 2011).

255. *See id.* (noting that suspension of the limitations period will allow the "recovery of payments made of profits" as well as of "withdrawals of principal beyond these mandated periods").

256. Martin Moylan, *Attorney Works to Claw Back Profits from* Petters *Fraud*, MINNESOTA PUBLIC RADIO (Sept. 30, 2010, 6:15 PM), http://m.mprnews.org/11135/show/7f05d29d57506561f092020046dfa252&t=dc479ab37488ed0ab68aa139be4ca762 (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

257. Goldstein, *supra* note 254.

245. Dave Beal, *Clawback Incorporated*, TWINCITIES BUSINESS (Jan. 2011), http://www.tcbmag.com/industriestrends/law/133625p1.aspx (last visited Sept.13, 2011) (on file with the Washington and Lee Law Review).

259. *See* Jake Anderson, *Attorneys Gather for* Petters *Clawback Hearing*, TWINCITIES BUSINESS (Jan. 19, 2011, 12:39 PM), http://tcbmag.blogs.com/daily_developments/2011/01/attorneys-gather-for-petters-clawback-hearing.html (last visited Aug. 9, 2011) (noting that the judge has not yet ruled on the statute of limitations) (on file with the Washington and Lee Law Review).

essentially all bankruptcy cases likely does comport with law. However, that does not prevent litigation, mean that the results were reached in a principled manner, or suggest that equitable principles actually prevailed. Moving forward, there are several options to promote predictability in situations where Ponzi schemes enter bankruptcy. The proposals range from legislative action to contractual measures, and from preventing clawbacks to substantially increasing their reach, but either extreme would introduce much-needed consistency into the law.

A. Proposed Legislation

New Jersey Representative Scott Garrett has introduced legislation to prevent the trustee representing Madoff's victims from pursuing additional clawback claims.[260] Garrett introduced a similar bill last session, and he believes that ordinary investors who were unaware of the fraud should not have to forfeit any portion of profits that were recorded on their monthly statements: "I introduced this legislation because I am increasingly concerned that the trustee in the Madoff case is ignoring the law and failing to provide prompt assistance to those who have been thrust into financial chaos."[261] Garrett's bill would protect investors who withdrew fictitious profits in good faith.[262]

New York Representative Gary Ackerman has introduced similar legislation to prevent trustees from clawing back money from investors in Ponzi schemes.[263] Ackerman's proposal was offered in conjunction with several other members of the House Financial Services Committee, and it limits clawbacks to being filed only against those who were "complicit or negligent in their participation in the Ponzi scheme."[264] It also extends

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260. *See* Jessica Holzer, *Bill Seeks to Shield Madoff Investors from Clawbacks*, WALL ST. J. (METROPOLIS) (Feb. 18, 2011, 10:18 AM), http://blogs.wsj.com/metropolis/2011/02/18/bill-seeks-to-shield-madoff-investors-from-clawbacks (last visited Aug. 9, 2011) (explaining that the bill will prevent Picard "from claiming funds from other Madoff investors") (on file with the Washington and Lee Law Review).

261. *Id.* (quoting New Jersey Representative Scott Garrett).

262. *See id.* ("[O]rdinary investors who didn't know about the fraud shouldn't have to forfeit any portion of profits that were recorded on their monthly statements.").

263. *Bill May Spare Mets' Owners in Madoff Clawback*, N.Y. TIMES (DEALBOOK) (May 14, 2010, 4:04 PM), http://dealbook.nytimes.com/2010/05/14/bill-may-spare-mets-owners-in-madoff-clawback/ (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

264. *Perlmutter & Members of Congress Introduce Legislation to Improve Relief for Victims of Madoff & All Ponzi Schemes*, CONGRESSMAN ED PERLMUTTER (Apr. 15, 2010),

$100,000 in SIPC protection to indirect investors who are currently excluded from coverage.[265] A co-sponsor of the bill, Peter King, stated: "While [Congress] unfortunately cannot return the full amount of funds that were greedily stolen in these Ponzi schemes, this legislation will put in protections that will provide some financial relief to the victims, restrict clawbacks, and restore investor confidence in the market."[266]

Both proposals protect good faith investors and are supported by compelling arguments, one of which is reliance: Investors who withdrew money and enjoyed its use for as many as six years were doing so in reasonable reliance. Moreover, financial investments always carry some risk, and those with funds still invested were presumably less risk-adverse or more willing to take a chance based on changing market conditions, or were at least better prepared for the shock of losing their investment. Ackerman's bill would also help parties with pressing monetary needs. Although providing $100,000 of protection to all defrauded investors, even those who invested through a hedge fund, may be nominal to heftier investors, it would go a long way towards helping those who need immediate financial assistance. However, neither proposal adequately protects investors against the narrowing of the good faith defense or sets forth a uniform approach by which trustees and courts must abide.

B. Congress Amending Preferential or Fraudulent Transfer Statutes

As suggested in this Note, the good faith defense is construed narrowly to allow the court to treat fraudulent transfers as preferences.[267] This allows avoidance of the transfers, and redistribution in a pro rata manner that the court deems more equitable. There is nothing inherently wrong with this approach. The problem resides in the fact that a narrowed good faith

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http://perlmutter.house.gov/index.php?option=com_content&view=article&id=726:perlmutter-a-members-of-congress-introduce-legislation-to-improve-relief-for-victims-of-madoff-a-all-ponzi-schemes&catid=33:press-releases&Itemid=15 (last visited Aug. 9, 2011) (on file with the Washington and Lee Law Review).

265. *See id.* ("Under the measure, SIPC would be required to provide up to $100,000 worth of insurance coverage to indirect investors in Ponzi schemes—those investors who invested through feeder funds and/or other indirect sources. Presently, SIPC only provides coverage to direct investors . . . .").

266. *Id.*

267. *See supra* note 172 and accompanying text (noting that courts purposefully construe the defense narrowly).

defense is a misapplication of the current law as written,[268] and inconsistent application of the law leads to uncertainty and disparate results. Although courts have inherent equitable power, "a bankruptcy court may not use its equitable powers to ignore the specific dictates of a bankruptcy statute."[269] Specific to Ponzi schemes that enter bankruptcy, Congress can certainly amend the preferential transfer statute to cover a more expansive amount of time or amend the fraudulent transfer statutes to abrogate the good faith defense. Uniform changes in the law need to be promulgated from the legislative branch, as opposed to being derived by individual judges in discrete cases.[270]

C. Contractual Measures in Investment Contracts

An interesting proposal by one group of commentators basically replicates the contractual corporate compensation clawback idea in the Dodd-Frank Act and applies it to investment contracts.[271] Instead of relying on courts to avoid transfers "at the back end—a remedy whose reach . . . is generally limited" to no recovery by the statute of limitations and to only profits by operation of the good faith defense, "the investor could in theory better protect herself prospectively by including a provision in the investment contract that would claw[]back all amounts paid out to investors contingent on the fund becoming insolvent as a result of the fraud."[272] Such a provision would have the effect of treating all transfers as preferential: No matter when the transfer was made, the entire amount—principal and fictitious profits—would be returned. It would operate like a rule of strict liability, as there would be no good faith defense. This proposal would treat all investors similarly because exact pro rata distribution would be possible.[273] The authors also suggest that such a provision would better reflect the expectations of investors:

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268. *See supra* notes 158, 160 (suggesting that Congress intended the good faith determination to be subjective).

269. Carlos J. Cuevas, *Bankruptcy Code Section 544(a) and Constructive Trusts: The Trustee's Strong Arm Powers Should Prevail*, 21 SETON HALL L. REV. 678, 679 (1991).

270. *See supra* note 173 and accompanying text (noting that it is Congress, not the courts, who should amend fraudulent transfer law.).

271. *See generally* Cherry & Wong, *supra* note 44 (proposing the inclusion of contractual measures in investment agreements to address multiple victim fraud).

272. *Id.* at 406.

273. *Id.*

> Such a risk distribution arguably reflects more accurately what the reasonable investor would have expected in the first instance, but which expectation turns out to be false and can be restored post facto only to a limited extent. Clawbacks in investment contracts therefore operate to ensure that investors' expectations concerning risk allocation are not shortchanged.[274]

There are potential problems with this proposal, a major one being the lack of contractual privity between investors.[275] The typical investment structure consists of individual contracts between the individual investor and the investment operator or fund.[276] Investors would be wary of signing a clawback agreement under which they would be bound "to surrender all funds received without the assurance other investors would do the same."[277] Essentially, such a provision would benefit co-investors while possibly serving to the detriment of the individual investor.[278] One way to overcome such a shortcoming is through a requirement of reciprocity: "[O]nly investors with similar provisions in their investment contracts would be permitted to enforce the clawback."[279] The authors also suggest that such terms might become standard in investment contracts over time because the risk is reallocated among investors while having no impact on the investment firm's liability.[280]

There is a strong public policy argument in favor of such contractual provisions. As the law currently stands, an investor has no incentive to discover a fraud, at least not until he recoups his principal (and possibly waits for the expiration of the reachback period to ensure he cannot be disgorged of his withdrawals).[281] "[B]ecause an investor subject to a contractual clawback will generally stand to recover more the earlier the

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274. *Id.*

275. *See id.* at 407 (noting that the lack of contractual privity is a "potential complication").

276. *Id.*

277. *Id.*

278. *See id.* (explaining that if the lack of contractual privity among the investors was not addressed, the clawback agreement "would function as a third-party beneficiary contract").

279. *Id.*

280. *See id.* at 408 (suggesting that an "investment fund would . . . have little incentive to remove . . . [default] clawback [terms] since the provision[s] [would] reallocate[] the risk of loss only as among the investors, and ha[ve] no impact on its bottom line").

281. *See* Jenkins, *supra* note 214 ("[T]he law is certainly a powerful disincentive to discovering ex post facto that you've invested in a Ponzi scheme, for reasons that the [current clawback] lawsuit[s] make[] obvious.").

fraud is discovered, the incentive structure is reversed in favor of disclosure at the earliest possible time."[282]

D. Amalgamated Proposal

Courts should uniformly utilize tracing principles when it is feasible to do so and only turn to pro rata distribution when tracing is not viable. As noted by the Restatement (Third) of Restitution & Unjust Enrichment, pro rata distribution should only occur when tracing is impossible.[283] Given the recent trend of courts allowing pro rata distribution, despite the ability of claimants to trace individually,[284] either Congress or the Supreme Court needs to mandate a return to traditional principles. Although the Restatement views these cases as anomalies,[285] it is hard to imagine that subsequent courts would not follow their precedent, especially given the confusion surrounding restitutionary principles.[286] The idea that tracing is

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282. Cherry & Wong, *supra* note 44, at 409.

283. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 reporter's note (g) (2011) ("[T]he orthodox approach to multiple-fraud cases returns identifiable assets to their owners, turning to pro rata distribution only when specific identification or transactional tracing is impossible.").

284. *See, e.g.*, cases discussed *supra* note 117 (noting that the district court had the authority to distribute assets pro rata). The Restatement (Third) of Restitution & Unjust Enrichment states that:

> The rule that is effectively being applied in cases like *Durham* imposes a liability for contribution between victims of a common fraud—though a liability imposed in the court's "discretion" . . . when the court sees fit . . . . Such a power has been asserted, without being identified, in a number of recent cases. Of the foregoing cases it can generally be observed—as the trial court [did] in *United States v. Durham* []—that "all claimants stand equal in terms of being victimized by the defendant defrauders. The ability to trace the seized funds to [particular claimants] is the result of the merely fortuitous fact that the defrauders spent the money of the other victims first." But that is not a basis for imposing a rule of contribution or "general average" between fraud victims—at least without a theory to explain how one set of victims becomes liable to another. The necessary principle is apparently one of loss-sharing between unrelated victims of a common casualty, but the decisions . . . do not purport to establish, delimit, or justify the principle necessary to explain the results, which appears inconsistent with fundamental rules of property.

RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 reporter's note (g) (2011).

285. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 reporter's note (g) (2011) ("Until these results are forthrightly explained and adequately justified, it seems safer to regard them as the product of error and inattention.").

286. *See supra* notes 48–51 and accompanying text (discussing the confusion

appropriate whenever it is practicable needs to be reiterated before more courts break with tradition and order pro rata distribution. As the Supreme Court stated in *Pearlman v. Reliance Insurance Co.*:[287] "The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors."[288]

Congress should clarify that the good faith standard in the Bankruptcy Code is subjective[289] and that fraudulent transfers should not be treated as preferential transfers. Just as courts often disregard tracing in favor of ratable distribution, courts also construe the good faith defense narrowly because it allows more transfers to be avoided and a resulting higher corpus to be distributed pro rata.[290] If Congress reaffirms a subjective standard, which would protect the principal of those who withdrew funds in actual good faith, extending the reachback period to cover the entire length of the Ponzi scheme becomes less problematic. Extending the reachback period would allow all profits received over the course of the Ponzi scheme to be avoided and redistributed from the estate on a pro rata basis. Only investors who knowingly participated or acquiesced in the fraud would be subject to returning all withdrawals—principal and profits—made over the course of the fraud. The modern push is towards achieving at least a rough parity between early and late investors, so extending the reachback period helps effectuate this goal.

If the reachback period is extended, the traditional equitable defense of "change in position" should be recognized: "If receipt of a benefit has led an innocent recipient to change position in such manner that an obligation to make restitution of the original benefit would be inequitable to the recipient, the recipient's liability in restitution is to that extent reduced."[291] This defense would function like the hardship defense by protecting early investors who are not in a position to repay the withdrawn funds. However, change in position would be applicable to all investors, not just those who are financially destitute. Even wealthy investors could benefit from the defense if they were able to

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surrounding restitution, especially within the bankruptcy context).

287. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 (1962) (reaffirming that "property rights existing before bankruptcy in persons other than the bankrupt must be recognized and respected in bankruptcy").

288. *Id.* at 135–36.

289. *See supra* notes 158, 161 and accompanying text (postulating that Congress intended a subjective standard).

290. *See supra* notes 172–73 and accompanying text (suggesting that the narrow reading of the good faith defense is an intentional effort by courts to put all investors at parity).

291. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 65 (2011).

prove that they used the withdrawn proceeds to fund an endowment or make charitable donations that they would not have otherwise made.[292]

If Congress extended the reachback period, reaffirmed that the good faith defense has a subjective standard, and recognized "changed circumstances" as a defense, the courts could reach all of the "phantom profits" while still protecting individual investors from excessive clawbacks that include their principal (so long as they acted in good faith). Only investors with actual knowledge of the fraud would be penalized with having to return withdrawn principal as well as profits. Such an approach balances the interests of early and late investors and mitigates the prejudice currently bestowed on wealthier or savvier investors.

Congress should also enact a provision protecting the investment of whistleblowers in order to encourage diligence on the part of investors and encourage earlier discovery of fraudulent schemes. Currently, the avoidance laws discourage investors from investigating the investment fund because if the investor finds it is fraudulent, he is subject to having his withdrawals reclaimed. "[T]he law is certainly a powerful disincentive to discovering ex post facto that you've invested in a Ponzi scheme, for reasons that the [current clawback] lawsuit[s] make[] obvious."[293] A possible solution would be to enact a whistleblower provision that allows the discovering investor to recover his entire principal, or that specifically exempts such a party from clawback lawsuits. This approach would presumably have minimal impact on the overall value of the estate and the recovery of the numerous other defrauded investors, but it would certainly provide a substantial incentive for the individual investor to reveal the fraud as soon as it is discovered. Even if the amount set aside for the whistleblower is substantial, by revealing the scheme earlier, the erring fiduciary will have dissipated fewer assets, which should more than offset any decrease in the corpus of the estate.

By limiting pro rata distribution to situations when tracing is impossible, traditional property and restitution rules will not be contravened.[294] A

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292. *See id.* § 65 cmt. c (explaining the defense of change in position). The Restatement comment states:

> [T]he fact that the recipient has spent the money is not of itself a defense to liability in restitution, because an expenditure of funds—without more—does not constitute a change of position. . . . [T]he recipient must demonstrate a causal relationship between receipt and expenditure: in other words, that the expenditure is one that would not have been made but for the payment or transfer for which the claimant seeks restitution.

Id.

293. Jenkins, *supra* note 214.

294. *See supra* notes 284–72 (discussing that pro rata distribution in cases where

subjective good faith defense protects all investors equally and makes an extension of the reachback period to encompass the entire Ponzi scheme reasonable because only parties with actual knowledge are forced to repay principal in addition to fictitious profits. Although the principal of innocent investors certainly should be protected (especially since they are likely to reasonably rely on funds that they have held possibly for decades), there is no comparable argument for parties who knowingly participated in a fraud. Finally, a whistleblower provision would transform the current disincentive of discovering fraudulent schemes into a powerful incentive for investors to vet funds and brokers before investing, remain diligent throughout the duration of their investment, and follow up on all "red flags."

VII. Conclusion

As noted by multiple commentators, the financial culture which allowed Madoff to flourish "largely remains in place today."[295] Given that Picard has already collected about half of the deficit, Madoff suggests that the "net losers" of his scheme are arguably in a better position than the investors who otherwise lost money in the 2008 financial decline.[296] Regardless of the relative recovery amount, it is apparent that the SEC is unequipped to catch fraud and is likely facing budget cuts that will only further hurt its efficiency.[297] Unless changes are made, "the fact remains that the time couldn't be riper for the next

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tracing is feasible is not supported by developed law).

295. Frank Rich, Op-Ed., *At Last, Bernie Madoff Gives Back*, N.Y. TIMES, Feb. 12, 2011, at WK8, *available at* http://www.nytimes.com/2011/02/13/opinion/13rich.html.

296. Steve Fishman, *The Madoff Tapes*, N.Y. MAG., Mar. 7, 2011, at 93, *available at* http://nymag.com/news/features/berniemadoff-2011-3/ (quoting a phone interview with Bernie Madoff). It is interesting to note that Madoff's victims might actually recover more than individuals invested in the stock market who sold at a loss. Madoff points out that the recovery is already at "50 cents on the dollar" and that many investors "probably would've lost all that money in the market" anyway. *Id.* Madoff may be correct. The S&P 500, which tracks the stock movement of the NYSE and NASDAQ, and is considered a bellweather for the U.S. economy, "lost about 56% of its value from the October 2007 peak to the March 2009 trough." Kiran Manda, *Stock Market Volatility During the 2008 Financial Crisis*, STERN SCHOOL OF BUSINESS, Apr. 1, 2010, at 2, *available at* http://w4.stern.nyu.edu/glucksman/docs/Manda2010.pdf.

297. *See* Sarah N. Lynch, *SEC Watchdog Tells of Waste but Is Cautious of Budget Cuts*, WESTLAW NEWS & INSIGHT (Feb. 10, 2011), http://westlawnews.thomson.com/National_Litigation/News/2011/02_-_February/SEC_watchdog_tells_of_waste_but_is_cautious_of_budget_cuts/ (last visited Aug. 9, 2011) ("Many Republicans unhappy with key provisions in the Dodd-Frank financial reform law have said they might try to keep the [SEC] from implementing them by starving its budget.") (on file with the Washington and Lee Law Review).

Madoff . . . to get in the game."[298] While we might be unable to predict or prevent the next Madoff,[299] we can at least have a consistent framework for working out restitution questions afterwards.

In the aftermath of a failed Ponzi scheme, some investors will inevitably be shortchanged. There is no easy answer when the losses resulting from fraud exceed the amount available for restitution. However, there is too much variance in the current law due to the discretion afforded to the court presiding over the distribution as well as to the trustee charged with recovering assets. Courts are given too much leeway in deciding whether to employ tracing or order pro rata distribution. The Reporter's Notes to the Restatement note that "the diminished familiarity of some courts with traditional equity techniques appears to have fostered a basic misconception: that the property rights of fraud victims may either be recognized or disregarded as a court may elect, to achieve a result the court views as desirable in a particular case."[300] By treating fraudulent transfers as preferences, the abrogation of the good faith defense has led to pro rata distribution in situations where it might not be justified. The lack of certainty leads to expensive, time-consuming litigation and delays the recovery of defrauded investors. The current concept of what is "equitable" burdens wealthy investors more heavily in that they are more likely to be targeted by the trustee, are ineligible for the hardship exception, must cover mediation costs, and are less likely to prevail under a good faith defense. Clarification of the law has the potential to streamline the recovery process, cut costs, and restore the equitable principles underlying the Bankruptcy Code. The newly published Restatement (Third) of Restitution & Unjust Enrichment is hopefully a good start in bringing clarity into an unwieldy area of the law,[301] and further action by Congress can help achieve parity between Ponzi scheme victims while protecting innocent investors and promoting the early discovery of fraudulent schemes.

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298. Rich, *supra* note 295.

299. *See* Cramer & Pilmer, *supra* note 36, at 28 ("[E]ven though all Ponzi schemes are certain to fail from their inception, it is just as certain that future schemers will devise new frauds and find new victims, if only until those frauds inevitably collapse.").

300. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 reporter's note (g) (2011).

301. *See* Rendleman, *supra* note 48, at 943 ("Progress and a better quality of justice for the law's consumers will follow a restatement of restitution that articulates and publicizes these unjust enrichment principles and makes the law of restitution available and more accessible to the legal profession.").