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## NET EQUITY ONLY COMES WITH NET EQUALITY: AN EXPLORATION OF AN ALTERNATIVE REMEDY FOR VICTIMS OF PONZI SCHEMES\*

### I. INTRODUCTION

Amid the financial catastrophe that persists in the United States today, one of the most damaging contributors unmasked is the array of fraudulent investment scams that have appeared in federal courts.<sup>1</sup> Although some justice is seen as fraudsters such as Bernard Madoff and R. Allen Stanford sit in prison,<sup>2</sup> such a consequence does not resolve the devastating financial loss that individuals and charitable organizations have suffered as a result of such schemes.

Upon the collapse of such a criminal plot, the court often appoints a trustee<sup>3</sup> to liquidate the conspirator's estate and recover as much of the phony investment as possible for purposes of equitable distribution among innocent investors.<sup>4</sup> As one theorist put it, the fantasy that the trustee will locate colossal bank accounts in the Caymans to fully compensate victims is generally replaced by the stunning actuality that "the elusive 'pot of gold' is in the pockets of the innocent victims who invested with the schemer."<sup>5</sup> Consequently, compensation often involves the "clawback" of various payments made before the scheme collapses.<sup>6</sup> Despite a long history of such schemes, the circuit courts have been unable to settle on a consistent and proper remedy for the innocent investors; in some instances, those who innocently profit from

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1. See, e.g., *Janvey v. Adams*, 588 F.3d 831 (5th Cir. 2009) (securities fraud action involving the collapse of R. Allen Stanford's multi-billion dollar portfolio); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010) [hereinafter *In re BLMIS*] (bankruptcy action involving the collapse of Bernard Madoff's \$64.8 billion portfolio).

2. See *United States v. Stanford*, 341 F. App'x 979 (5th Cir. 2009) (denying bail to Stanford); Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1 (quoting Madoff's lawyer who stated that "Madoff expects to 'live out his years in prison'").

3. In bankruptcy cases, the court-appointed representative of investors is known as a trustee. If the company does not formally file for bankruptcy, the representative is known as a receiver. For purposes of this Comment, these terms are used interchangeably.

4. See, e.g., *In re BLMIS*, 424 B.R. at 126 (noting that a Dec. 15, 2008 protective order appointed a trustee for the liquidation of the defendant's business).

5. Sandra S. Benson, *Follow the Money*, TENN. B.J., Sept. 2010, at 12, 13; see also Theo Emery, *Illusion of Success Gives Way to Suits and Suicide*, N.Y. TIMES, Nov. 10, 2007, at A12 ("There were no hidden accounts, no buried chest of cash . . . 'It would be good if we could find a pot of gold at the end of the rainbow . . . We didn't find it.'").

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

fraud (“net winners”) have been untouched by trustees at the expense of those who do not (“net losers”), although at other times, net winners have been stripped of life savings to repay fellow investors who did not withdraw sufficient funds in time.<sup>7</sup>

This Comment analyzes the various remedies put forth by federal courts in the most famous fraudulent investment schemes of the past century and ultimately presents an alternative solution that has yet to be explored: the clawback of principal investments by net winners and net losers alike. In no way does this Comment suggest that this potential response is perfect or should be widely applied. It is simply a formula that could be applicable in certain circumstances, allowing it to subdue some of the inefficient litigation and inequitable rulings that victims must endure after already suffering dreadful harm. In short, it is a moderate suggestion that the current practice of prohibiting clawback of principal from innocent investors should not be the uniform remedy for Ponzi schemes.

The analysis begins with an introduction to the various types of Ponzi schemes, including descriptions of how they operate and examples of the havoc they subsequently wreak. Part II.B discusses the recovery process, the various options available to victims, and the usual effectiveness of each. Part II.C summarizes the remedies thus explored by the courts, including the clawback and distribution systems currently in place. Part III.A enumerates problems with the current approach, whereas Part III.B discusses its advantages. Part III.C puts forth the idea of clawing back principal investments from victims of Ponzi schemes as an alternative remedy with limited applicability. Part III.D concedes the various obstacles with implementing such a practice, whereas Part III.E explains its limited reach. Finally, Part III.F outlines additional considerations in light of the fact that Ponzi schemes persist despite stiff penalties for the criminal operators at the hands of the courts, protective efforts by government organizations, and increased awareness by the public.

## II. OVERVIEW

### A. *An Introduction to Ponzi Schemes*

The modern Ponzi scheme is named after Charles Ponzi, who promised fifty percent returns in three months through the purchase of international postal coupons, when in truth no investments were made.<sup>8</sup> Instead, he merely moved payments of principal from later investors to cover the “interest” payments of earlier investors.<sup>9</sup> Since no investments are ever actually made in Ponzi schemes and “interest” payments

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7. Compare *In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 87–88 (2d Cir. 2004) (basing recovery entirely on net investments instead of customers’ legitimate expectations of account value), and *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995) (ruling that one particular net winner return net profits because he should not benefit from fraud), with *Donell v. Kowell*, 533 F.3d 762, 780 (9th Cir. 2008) (allowing at least one investor to retain fictitious profits from the fraud amounting to an eighty-three percent return on his initial investment while leaving others with a return of only pennies to the dollar), and *Visconsi v. Lehman Bros.*, 244 F. App’x 708, 713 (6th Cir. 2007) (finding a return of the full amount originally invested less any withdrawals to be a wholly inadequate measure of damages).

8. *Cunningham v. Brown*, 265 U.S. 1, 7–8 (1924).

9. See *id.* at 8 (explaining that Ponzi was only able to pay investors by obtaining new investments).

are actually the nest eggs of others, the entire system is really just a house of cards doomed from its inception.<sup>10</sup> Problems arise when the system manages to survive for long enough that certain investors end up acquiring returns in excess of principal that they believe to be honest profits, while other investors are often left with next to nothing at the time the system implodes.<sup>11</sup>

Ponzi schemes can take many forms in the way the house of cards is constructed by the criminal operator. In Bernard Madoff's case, he convinced investors over the course of roughly forty years that he was purchasing securities through a "split-strike conversion strategy," which in truth was illusory and involved no investments at all.<sup>12</sup> In reality, all funds offered by creditors were deposited in an ordinary account at Chase Bank and withdrawn for the personal use of Madoff and his associates.<sup>13</sup> To keep investors in the dark about trading activity, Bernard L. Madoff Investment Securities LLC (BLMIS) used an archaic computer system that "prevented customers from obtaining electronic, real-time online access to their accounts, as was customary in the industry by the year 2000, and instead generated paper trade confirmations."<sup>14</sup> Alternatively, BLMIS provided its oblivious customers with monthly statements that reported fabricated amounts far exceeding their capital deposits.<sup>15</sup> When asked how Madoff accomplished these remarkable returns,<sup>16</sup> he refused to disclose any specifics<sup>17</sup>

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10. See *Terry v. June*, 432 F. Supp. 2d 635, 640 (W.D. Va. 2006) (explaining that the operator of a Ponzi scheme invariably knows that the scheme cannot last forever); *In re Taubman*, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993) (describing how the nature of a Ponzi scheme ensures its demise); Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 370 (2009) (calling Madoff's operation a "house of cards").

11. Cherry & Wong, *supra* note 10, at 396–97.

12. The "split-strike conversion" strategy is discussed in the *In re BLMIS* case:

Under this strategy, Madoff purportedly invested customer funds in a subset, or "basket," of Standard & Poor's 100 Index ("S & P 100 Index") common stocks, and maximized value by purchasing before, and selling after, price increases. Several times per year, customer funds would move "into the market," whereby a basket of stocks was supposedly purchased. Customer funds were then moved entirely "out of the market" to "invest" in United States Treasury Bills, money market funds, and cash reserves until the next trading opportunity. This continued until the end of each quarter, when all baskets would be sold and "invested" in these "out of the market" repositories. Focusing on large cap stocks, the strategy evaded inquiry into the volume of stocks in which BLMIS was fictitiously trading. Madoff's quarter-end liquidation of the split-strike security basket positions enabled him to avoid disclosure of the equities in the baskets required by SEC Form 13F. BLMIS also devised a hedging strategy to purchase and sell S & P 100 Index option contracts corresponding to the stocks in the baskets. This allowed Madoff to appear to manage the downside risk associated with possible unfavorable price changes in the baskets and limit profits associated with increases in underlying stock prices.

424 B.R. 122, 129–30 (Bankr. S.D.N.Y. 2010) (footnote omitted).

13. *Id.* at 130.

14. *Id.* at 131.

15. *Id.* at 129.

16. Erin E. Arvedlund, *Don't Ask, Don't Tell: Bernie Madoff Is So Secretive, He Even Asks His Investors to Keep Mum*, BARRON'S, May 7, 2001, at 26 (reporting that at one point, Madoff's accounts "produced compound average annual returns of 15% for more than a decade" and ranked among the world's five largest hedge funds).

17. *Id.* ("It's a proprietary strategy. I can't go into it in great detail.")

and commanded comparable secrecy from his investors.<sup>18</sup> The substantial gains that investors were led to believe they had achieved alleviated any desire on their behalf to inquire, allowing criminal activity to persist.

R. Allen Stanford duped investors in a similar nearly fifteen-year operation through the sale of certificates of deposit (CDs) issued by Stanford International Bank.<sup>19</sup> Stanford “promis[ed] above-market returns and falsely assur[ed] investors that the CDs were backed by safe, liquid investments.”<sup>20</sup> In an even more creative plot, one devious corporation attracted new investors to buy solar energy production modules from which they earned “power payments” over time for energy their modules never actually produced.<sup>21</sup> More recently, former football phenom John Elway and a business partner invested \$15 million in a purported hedge fund that collapsed with \$71 million in ten years of net investments, \$9.5 million in remaining cash and investments, and \$45 million in liabilities.<sup>22</sup>

Despite the various groups targeted and fictional investment techniques advertised, the common link among all of these is the unhappy ending: complete collapse immediately followed by tragedy among innocent and trusting investors. Examples include loss of college funds,<sup>23</sup> depletion of life savings,<sup>24</sup> destruction of charities,<sup>25</sup> and depression-induced suicide.<sup>26</sup> Tragedy also extends to the operators’ families, who may not even be aware of the fraudulent activity.<sup>27</sup> This widespread misfortune is unavoidable; Ponzi schemes by their very nature have a zero percent

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18. *Id.* (“If you invest with me, you must never tell anyone that you’re invested with me. It’s no one’s business what goes on here.”).

19. *Janvey v. Adams*, 588 F.3d 831, 833 (5th Cir. 2009).

20. *Id.*

21. *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590–91 (9th Cir. 1991) (noting investors spent \$200 million on this plot).

22. Greg Griffin, *Elway Invested Millions in Scam He and a Partner Entrusted \$15 Million with a Fund Chief Later Accused of Fraud*, DENVER POST, Oct. 14, 2010, at A1

23. *E.g.*, Email from Anonymous Victim of Bernard Madoff’s Ponzi Scheme to United States Attorney’s Office of the Southern District of New York (Mar. 7, 2009, 2:52 PM EST), available at [http://online.wsj.com/public/resources/documents/madoff\\_emails3\\_20\\_09-1.pdf](http://online.wsj.com/public/resources/documents/madoff_emails3_20_09-1.pdf) [hereinafter Email from Madoff Victim] (“My retirement and my son’s college fund[s] [are] all gone.”).

24. *See, e.g.*, Michael Rothfeld, *The Madoff Fraud: Madoff Investors Brace for Lawsuits*, WALL ST. J., July 26, 2010, at C1 (describing an 87-year-old woman who had her life savings with Madoff, including life insurance proceeds from her husband’s death).

25. *See, e.g.*, Patrick Healy, *The Play on Madoff, Without Wiesel*, N.Y. TIMES, July 20, 2010, at C1 (noting that Elie Wiesel and his wife lost their life savings and their charitable foundation suffered a loss of \$15.2 million as a result of investing with Madoff).

26. *See, e.g.*, Alex Berenson & Matthew Saltmarsh, *The Suicide of a Trader Contributes to Mysteries*, N.Y. TIMES, Jan. 2, 2009, at B1 (recounting the suicide of Rene-Thierry Magon de la Villehuchet, a money manager who could not live with the guilt and responsibility associated with losing upwards of \$1.4 billion of his and his clients’ money with Madoff); Emery, *supra* note 5 (recounting the tragedy of Robert W. McLean, a Tennessee investment manager who shot and killed himself a day before the bankruptcy hearing in which he was expected to confront customers he had cheated).

27. *See, e.g.*, Diana B. Henriques & Al Baker, *A Madoff Son Hangs Himself on Father’s Arrest Anniversary*, N.Y. TIMES, Dec. 12, 2010, at A1 (describing how Mark Madoff committed suicide on the second anniversary of his father’s arrest amid allegations that he knew of his father’s fraud and may have been involved).

opportunity for success since money is simply pooled and passed around, with substantial amounts consistently being skimmed off.<sup>28</sup>

Knowing the end to these unspeakable catastrophes, the obvious question that comes to mind is, how do they even begin? One analyst cleverly recognized that “[m]any Ponzi operators target specific religious or ethnic groups to get their schemes off the ground,” using an established affinity and trust to form the basis for credibility.<sup>29</sup> Charles Ponzi targeted fellow Italian immigrants, Madoff took advantage of the Jewish community and its charities, whereas Reed Slatkin’s \$600 million operation largely preyed on Scientology followers.<sup>30</sup> A list of recent affinity fraud schemes published by the Securities and Exchange Commission (SEC) shows that a wide spectrum of groups has been cheated.<sup>31</sup> Although this exclusivity has the capability of providing group members with an illusion of elite status, the unfortunate reality is a decrease in transparency that further cloaks a conspiracy with devastating ramifications.<sup>32</sup>

It comes as no surprise as to how the schemes continue after the initial launch. Existing investors often admit after the scheme’s collapse that they had no reason to withdraw their principals because of the substantial “interest” payments they consistently received.<sup>33</sup> Word quickly spreads of the immense returns, and early investors recommend the lucrative venture to their friends.<sup>34</sup> Another common technique for promoting the “investment opportunity” and the notoriety of the debtor himself is through large, consistent charitable donations on his behalf.<sup>35</sup> “[T]he theory is that the donations of stolen money are made to further Ponzi schemes by giving the donor status and access to powerful, wealthy people.”<sup>36</sup> Sometimes these contributions are so substantial that they comprise among the biggest pools of money that the receiver pursues.<sup>37</sup>

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28. See *supra* note 10 and accompanying text for a discussion of how a Ponzi scheme is doomed from its inception.

29. R. Alexander Pilmer & Mark T. Cramer, *Swindlers’ List: Formal Dissolution Proceedings Are Usually Necessary to Sort Through the Wreckage of Failed Ponzi Schemes*, L.A. LAW., June 2009, at 22, 24.

30. *Id.*

31. *Affinity Fraud: How to Avoid Investment Scams that Target Groups*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/investor/pubs/affinity.htm> (last modified Sept. 6, 2006) (enumerating group victims of affinity fraud such as Jehovah’s Witnesses, retirees, Korean Americans, Armenian Americans, Baptists, and others).

32. See Aaron Lucchetti & Tom Lauricella, *The Madoff Fraud Case: Investors Were Told They Had a Total of \$64.8 Billion*, WALL ST. J., Mar. 11, 2009, at A2 (reporting that because Madoff’s investors “felt privileged to be clients,” they “[did not] ask too many questions”); cf. *Brown v. Brandenburg (In re McGee)*, No. 97-50234, 2000 Bankr. LEXIS 1865, at \*11 (Bankr. E.D. Ky. Nov. 22, 2000) (describing conspirator as a “pillar” of his church, who targeted elderly retirees in a theft involving over \$4 million).

33. See Lucchetti & Lauricella, *supra* note 32 (“Because returns were so steady, investors had little need to redeem their money, and many of them were clients for decades.”).

34. See, e.g., Email from Madoff Victim, *supra* note 23 (describing how “a trusted life-long friend introduced [the victimized investor] to Madoff”).

35. See, e.g., Benson, *supra* note 5, at 13 (describing one Ponzi operator’s generous donations, including \$1.5 million to the Country Music Hall of Fame and \$1 million in tuition and expenses for scholarship students).

36. Harold Brubaker, *A Workout in Court over Ponzi-Scheme Gift*, PHILA. INQUIRER, July 7, 2010, at E1.

37. *Id.*

Whether or not victims were part of a common group before the scheme collapsed, the recovery process almost guarantees at least some joint actions by investors. In seeking relief through the legal process, victims of Ponzi schemes fall into a series of classifications based on their deposit and withdrawal histories.<sup>38</sup> “Net winners” are those claimants that withdrew funds, which they legitimately believed to be profits, from their fictional account with the schemer in excess of their initial investment of principal and subsequent deposits.<sup>39</sup> “Net losers” are those claimants that withdrew less money than their total principal and deposits.<sup>40</sup> The federal courts have explored various remedies to compensate those who have lost—often at the expense of those who have managed to profit—but numerous factors make a full recovery unrealistic and uncommon no matter the form implemented.<sup>41</sup>

### B. *The Recovery Process*

When a Ponzi scheme breaks down, the fraudulent body can file for bankruptcy,<sup>42</sup> liquidate in bankruptcy court subject to the Securities Investors Protection Corporation (SIPC),<sup>43</sup> or fall to an SEC receivership.<sup>44</sup> Creditors, on the other hand, can file for relief under the Federal Bankruptcy Code, petition a state court for the appointment of a receiver to liquidate the schemer’s assets, or pursue individual lawsuits against the schemer himself.<sup>45</sup> “The difference is procedural, not substantive, because the trustee’s restitution claim—asserted on behalf of the creditors—is essentially the same one that fraud victims might assert themselves outside bankruptcy.”<sup>46</sup> No matter which is ultimately pursued, all options allow for limited recovery by victims of fraudulent investment schemes.

#### 1. Claims Through the SIPC

A common avenue for recovery is a claim through the SIPC, which Congress created to insure certain investor accounts against the failure of brokerage firms.<sup>47</sup> Federal statute requires that the SIPC provide \$500,000 for securities losses and

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38. See *infra* Part II.C.1 for a discussion of the Net Investment Method for calculating net equity.

39. *In re BLMIS*, 424 B.R. 122, 132 (Bankr. S.D.N.Y. 2010).

40. *Id.*

41. See, e.g., Benson, *supra* note 5, at 13 (describing the “common problem” in Ponzi schemes that “the schemer has few assets left to satisfy the claims” perhaps due in part to “generous donations to charities”); Brubaker, *supra* note 36 (describing the effect of donating to charities with funds that the Ponzi schemer misappropriated); Rothfeld, *supra* note 24 (offering to exempt people who can prove hardship, such as those who would lose their homes).

42. See generally *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.* (*In re Bayou Grp., LLC*), 396 B.R. 810 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part sub nom.* *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC* (*In re Bayou Grp., LLC*), 439 B.R. 284 (S.D.N.Y. 2010).

43. See generally *In re BLMIS*, 424 B.R. 122 (discussing the Madoff fraud).

44. See generally *Janvey v. Adams*, 588 F.3d 831 (5th Cir. 2009) (describing the Stanford fraud). For further discussion of these three options, see Barasch & Chesnut, *supra* note 6, at 924.

45. Benson, *supra* note 5, at 14.

46. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 67 cmt. i (2011).

47. *Our 40-Year Track Record for Investors*, SIPC: SEC. INVESTOR PROT. CORP., <http://www.sipc.org/who/sipctrackrecord.html> (last visited Mar. 3, 2012).

\$250,000 for cash losses.<sup>48</sup> Nevertheless, “[g]iven that SIPC is a private insurer and that being statutorily eligible for coverage is not tantamount to receiving it, [some speculators] find it conceivable that SIPC will seek to deny coverage on claims, spawning coverage litigation.”<sup>49</sup>

The overall effectiveness of the SIPC is further suppressed by the fact that many Ponzi scheme victims invest through feeder funds<sup>50</sup> and are therefore ineligible for SIPC compensation as individuals.<sup>51</sup> Courts have ruled that the funds themselves, but not the indirectly invested persons, are entitled to the \$500,000 payout, leaving individuals only to hope for pro rata distribution, which typically amounts to a negligible recovery.<sup>52</sup> The effect of this ruling is especially powerful in the Madoff case, for example, because of the sheer volume of feeder funds that were duped into investing.<sup>53</sup> For those that indeed receive the full \$500,000 relief, this value still often represents a mere drop in the bucket of their net investment and even less in relation to their belief as to the value of their account.<sup>54</sup> In the aggregate for the Madoff case, for example, total SIPC commitments amount to a mere two percent of the total principal invested and roughly one percent of the purported value of the operation.<sup>55</sup>

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48. Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff-3(a), (d) (2006 & Supp. IV 2010).

49. Therese M. Doherty et al., *Madoff Victims Face Litigation Landscape Filled with Uncertain or Unsatisfying Recoveries and, Worst of All, the Prospect of Losing More*, LEXISNEXIS EMERGING ISSUES ANALYSIS, Apr. 30, 2009, available at LEXIS, 2009 Emerging Issues 3571.

50. The term “feeder fund” refers to any money management vehicle that aggregates the investments of numerous individuals and then places them in the Ponzi scheme, oblivious to its fraudulent character. *See, e.g., The Madoff Fraud: Investors Win \$12.74 Million in Madoff Feeder-Fund Case*, WALL ST. J., Sept. 4, 2010, at B11 (“Like many of Mr. Madoff’s victims, the Sandalwood funds invested in feeder funds such as Gabriel Capital, which transferred money to Mr. Madoff to manage.”); Aaron Smith, *Tough Luck for Madoff Feeder Fund Investors*, CNNMONEY (Dec. 11, 2010, 12:36 PM), [http://money.cnn.com/2010/12/09/news/companies/madoff\\_feeder\\_funds](http://money.cnn.com/2010/12/09/news/companies/madoff_feeder_funds) (describing how the majority of Madoff’s victims utilized feeder funds instead of investing directly). This lump sum is invested in the name of the fund, and therefore the fund is eligible for protection from SIPC, whereas individuals are not. Smith, *supra*. In the *Madoff* case for example, although some individuals invested their money directly with BLMIS, the majority of investors utilized feeder funds. *Id.* In some instances, an individual’s money would pass through numerous funds before reaching the scheme. *Id.*

51. Doherty et al., *supra* note 49; Smith, *supra* note 50.

52. *See, e.g., Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co., Inc.*, 533 F.2d 1314, 1321 (2d Cir. 1976) (awarding SIPC benefits to entire funds, not individuals who invested in the fraud through those funds). *See also* Smith, *supra* note 50 (quoting some people who call the distribution unfair as well as others who say that investing in feeder funds is buyer beware, leaving it up to the individual to investigate the fund’s endeavors).

53. *See* Lucchetti & Lauricella, *supra* note 32 (noting that “Madoff apparently counted on feeder funds that vacuumed up cash around the world”).

54. *See, e.g.,* Rothfeld, *supra* note 24 (describing one elderly victim who did not want to have to repay almost \$700,000 of her nearly \$3 million account, which included her life savings, because she would be left penniless).

55. *See* Bob Van Voris, *Trustee in Madoff Case Recovers Nearly \$850K. He Spends \$26.9M Over Same Six Months*, STAR-LEDGER (Newark, N.J.), Nov. 2, 2010, at 26 (describing expenses of the trustee overseeing the bankruptcy of Madoff’s firm in relation to the amount recovered); *see also* Jane J. Kim, *The Madoff Fraud: SIPC Sets Payouts in Madoff Scandal*, WALL ST. J., Oct. 29, 2009, at C4 (reporting these numbers to be even lower and that the Madoff SIPC payout eclipses all other SIPC payouts since 1970 combined, which amount to \$520 million).

## 2. Liquidating the Ponzi Operator's Estate

Another path instinctively traveled is that of liquidating the estate of the schemer himself. This power is also authorized by the Securities Investor Protection Act (SIPA)<sup>56</sup> and occurs after the court appoints a trustee.<sup>57</sup> The appointment of a trustee “is both necessary and appropriate in order to prevent waste and dissipation of the assets of [d]efendants to the detriment of the investors.”<sup>58</sup> Trustees are appointed by court order,<sup>59</sup> often as a result of their extensive experience with bankruptcy litigation.<sup>60</sup> In large-scale operations, such as that of Madoff, the trustee often works tirelessly, filing lawsuits and meeting deadlines.<sup>61</sup>

Once appointed, the bankruptcy trustee must collect any available assets in order to pay losing investors and the estate's other creditors.<sup>62</sup> While on the surface it may seem that the portions stolen for the criminal's own benefit might be recoverable from the estate, the reality is that very few assets become available, either because the schemer has squandered the money or has hidden it in foreign bank accounts.<sup>63</sup> Having actually not executed any trades, there are often no investments to convert to cash either.<sup>64</sup> Even in the instance of a “successful” liquidation of a large estate, total collections often represent a mere drop in the bucket.<sup>65</sup> The main reason for this shortcoming is that most of the cash has been redistributed among investors.<sup>66</sup>

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56. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa–III (2006).

57. *Id.* § 78eee(b)(3).

58. Amended Order Appointing Receiver at 1, SEC v. Stanford Int'l Bank, Ltd., No. 3-09CV0298-N (N.D. Tex. Mar. 12, 2009).

59. *See, e.g., In re BLMIS*, 424 B.R. 122, 126 (Bankr. S.D.N.Y. 2010) (noting that a Dec. 15, 2008 protective order appointed Irving Picard as trustee for the liquidation of Madoff's business).

60. *See, e.g., Find Lawyers: Irving H. Picard*, BAKER HOSTETLER, <http://www.bakerlaw.com/irvingpicard> (last visited Mar. 3, 2012) (identifying the Madoff trustee, Irving H. Picard, as having participated as counsel in at least thirty-eight bankruptcy decisions).

61. *See, e.g., Michael Rothfeld, Global Finance: Madoff Trustee Files Flurry of Suits*, WALL ST. J., Nov. 29, 2010, at C3 (reporting that Picard filed forty lawsuits in an attempt to recover less than one percent of the total funds missing).

62. 15 U.S.C. § 78fff-1; *see also* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (1998).

63. *See, e.g., Amir Efrati, Prosecutors Set Sights on Madoff Kin*, WALL ST. J., Feb. 12, 2010, at C1 (“Madoff family members . . . used [the fraudulent account] as a ‘piggy bank’ to pay for personal expenses such as homes, cars and boats, as well as credit-card charges for restaurants and vacations.”); Edward Wyatt, *Whistle. Then Worry and Wait.*, N.Y. TIMES, Oct. 10, 2010, at B1 (reporting on the \$160 million Ponzi operation of Trevor G. Cook, headquartered in Minneapolis, where regulators discovered nineteen foreign accounts at seventeen institutions in twelve countries).

64. *See, e.g., Pilmer & Cramer, supra* note 29, at 24 (“Although Ponzi convinced more than 20,000 people to invest more than \$10 million, an audit of Ponzi's assets after the scheme collapsed turned up less than \$100 worth of postal coupons.”).

65. Recall that the total account value of the Madoff operation was approximately \$65 billion. Van Voris, *supra* note 55. Madoff's assets at the time the operation was discovered were approximately \$826 million, which is under two percent of the total value of the operation. *See* Chad Bray, *Madoff Lists \$826 Million In Assets, Give or Take*, WALL ST. J., Mar. 14, 2009, at B1.

66. *See supra* notes 5–6 and accompanying text for a discussion of how this startling realization eventually supersedes the commonly held “pot of gold” illusion.

Consequently, liquidating the estate of the Ponzi operator is often inadequate and unreliable in repaying investors.

### 3. Clawbacks

Expectedly, the SIPC reimbursements and estate liquidation provide relief for only some investors and represent a small percentage of net investments. Trustees often turn to avoidance actions—known as “clawbacks”—as outlined in the preference and fraudulent transfer provisions of the Bankruptcy Code.<sup>67</sup> Clawbacks represent an attempt to “redistribute payments made in the course of the fraud, in either an attempt to make defrauded parties whole or to prevent unjust enrichment.”<sup>68</sup> In fact, the funds that were distributed as “returns” to certain investors often represent the largest assets of a Ponzi scheme estate.<sup>69</sup> Depending on timing, preference and fraudulent transfer actions have the potential to reach both payments of fictitious profits and redemptions of principal.<sup>70</sup>

#### a. Preferences and Fraudulent Transfers

Regarding preferences, the trustee may avoid any transfer of an interest of the debtor (i.e., the Ponzi operator) that either benefitted a creditor (i.e., the innocent investor) or occurred within ninety days of the bankruptcy petition.<sup>71</sup> The two main goals of the preference section are to discourage creditors “from racing to the courthouse to dismember the debtor during the debtor’s slide into bankruptcy” and to “facilitate the prime bankruptcy policy of equality of distribution.”<sup>72</sup> Ultimately, preference actions “spread the effect of the bankruptcy across a greater number of creditors and prevent earlier-paid creditors who received money immediately prior to the bankruptcy from receiving a windfall.”<sup>73</sup> Although there is an exemption for payments made in the ordinary course of business, redemption payments to investors typically do not meet the exemption and are instead considered preferential transfers.<sup>74</sup> Nevertheless, the success of this remedy often pales in comparison to the amount of funds transacted outside of ninety days, which is especially true based on large Ponzi schemes which are sustained for many years.<sup>75</sup>

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67. See McDermott, *supra* note 62, at 158–60 (forwarding the Bankruptcy Code as an alternate method of recovery).

68. Barasch & Chesnut, *supra* note 6, at 922.

69. McDermott, *supra* note 62, at 158.

70. Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 223 (2009).

71. See 11 U.S.C. § 547(b) (2006) (outlining a trustee’s permitted avoidances in preference actions).

72. 5 COLLIER ON BANKRUPTCY ¶ 547.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) [hereinafter, COLLIER ON BANKRUPTCY].

73. Pilmer & Cramer, *supra* note 29, at 23.

74. Danning v. Bozek (*In re* Bullion Reserve of N. Am.), 836 F.2d 1214, 1219 (9th Cir. 1988); Barasch & Chesnut, *supra* note 6, at 926.

75. Compare *Cunningham v. Brown*, 265 U.S. 1, 7–8 (1924) (describing the eponymous Ponzi scheme, which lasted under a year), with *In re BLMIS*, 424 B.R. 122, 127 (Bankr. S.D.N.Y. 2010) (describing the Madoff fraud, which may have lasted as long as forty years).

The Bankruptcy Code also permits a trustee to avoid any transfer by the debtor within two years of the bankruptcy petition.<sup>76</sup> “[F]raudulent transfer law allows creditors to avoid transactions which unfairly or improperly deplete a debtor’s assets or that unfairly or improperly dilute the claims against those assets.”<sup>77</sup> Congress set a reachback period of two years based on the notion that it is within this time that most of the fraudulent transfers occur.<sup>78</sup> Still, many schemes are sustained for longer, so in addition to this two-year reachback period, a trustee may also invoke state law in the same bankruptcy proceeding to recover fraudulent conveyances.<sup>79</sup> Almost all states have enacted the Uniform Fraudulent Transfer Act (UFTA).<sup>80</sup> Although the UFTA provides for various reachback periods depending on the type of transfer, the reachback period among states is almost uniformly four years.<sup>81</sup>

*b. Unjust Enrichment*

The reason behind these avoidance powers is that generally, “[a] person who is unjustly enriched at the expense of another is subject to liability in restitution.”<sup>82</sup> Moreover,

[i]t is clear that each defrauded investor has a claim in restitution to recover at least the amount of his net loss. The question in the present context is the extent to which funds previously paid out to innocent investors are subject to restitution in favor of the other victims.<sup>83</sup>

One court held that “an innocent investor in a Ponzi scheme is not unjustly enriched when he receives returns on his investment in good faith and while ignorant of the scheme, so long as the returns do not exceed the amount of the original investment.”<sup>84</sup> In other words, the oblivious, good-faith net winner is subject to clawback of any “profits” received but is entitled to keep the principal investment. Although it is important to note that this was the finding of a state court addressing an unjust enrichment suit outside of the realm of federal bankruptcy law,<sup>85</sup> bankruptcy rulings across the circuit courts have consistently upheld this concept by demanding from good-faith net winners only the payback of amounts in excess of capital.<sup>86</sup> The original Restatement of Restitution also provides some insight into this matter:

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76. 11 U.S.C. § 548(a)(1).

77. COLLIER ON BANKRUPTCY, *supra* note 72, ¶ 548.01.

78. STAFF OF HOUSE COMM. ON THE JUDICIARY, 74TH CONG., ANALYSIS OF H.R. 12889, 215 (1936).

79. Wiener, *supra* note 70, at 225 (citing 11 U.S.C. § 544(b)).

80. See COLLIER ON BANKRUPTCY, *supra* note 72, ¶ 548.01B (listing forty-three states and the District of Columbia as having adopted the UFTA).

81. *Id.* ¶ 548.09[1][b].

82. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 (2011). See generally William J. Woodward, Jr., “Passing-on” the Right to Restitution, 39 U. MIAMI L. REV. 873 (1985).

83. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 67 cmt. f.

84. Chosnek v. Rolley, 688 N.E.2d 202, 210 (Ind. Ct. App. 1997).

85. See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 67, reporter’s note at 581 (“[T]he relevant claims and defenses in this context have their source in the law of restitution, independent of bankruptcy law and the statutes governing fraudulent transfer.”).

86. See, e.g., Donell v. Kowell, 533 F.3d 762, 771–72 (9th Cir. 2008) (limiting clawbacks to “profits”); Scholes v. Lehmann, 56 F.3d 750, 757–58 (7th Cir. 1995) (requiring a Ponzi scheme investor to return net-

A person who has entered into a transaction with another under such circumstances that, because of a mistake, he would be entitled to restitution from the other,

(a) is not entitled to restitution from a third person who has received title to or a legal interest in the subject matter either from the other or from the transferor at the direction of the other, and has given value therefor without notice of the circumstances;

(b) is entitled to restitution from a third person who had notice of the circumstances before giving value or before receiving title or a legal interest in the subject matter.<sup>87</sup>

In sum, various legal authorities have firmly ruled that distribution of principal absent bad faith does not amount to unjust enrichment of an innocent investor.

*c. Constructive Versus Actual Fraud*

Independent of the combination of state and federal law that the trustee pursues, the two theories of recovery that he can allege against a Ponzi operator are constructive fraud and actual fraud.<sup>88</sup> Under constructive fraud, the debtor must have received less than a reasonably equivalent value in return when insolvency was imminent, whereas under actual fraud, he must also have had actual intent to hinder, delay, or defraud creditors.<sup>89</sup> Clawback claims brought under the theory of constructive fraud are generally limited to recovery of fictitious profits earned by the investor and do not include a return of principal.<sup>90</sup> This is based on the idea that “profits gained” represent theft from other investors and therefore are not reasonably equivalent to the initial investment.<sup>91</sup> A trustee who proves actual fraud can theoretically recover all transfers to the investor, including fictitious profits and principal, because “[t]he mere existence of a Ponzi scheme is sufficient to establish actual intent to defraud.”<sup>92</sup>

Despite this possibility of recovering principal, fraudulent transfer provisions under the Bankruptcy Code and UFTA are subject to a defense of good faith, effectively eliminating any difference in the recoverable amount between the two theories.<sup>93</sup> An investor is “deemed to have given value or consideration in exchange for

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profits); *Eby v. Ashley*, 1 F.2d 971, 973 (4th Cir. 1924) (holding that profits received were without consideration); *Lawless v. Anderson (In re Moore)*, 39 B.R. 571, 575 (Bankr. M.D. Fla. 1984) (“[The net winner] in this case was more zealous in shepherding his ‘investment’ than were some of the others who were lured by the prospect of a deal too good to be true. Equity does not permit his zeal to be rewarded.”).

87. RESTATEMENT (FIRST) OF RESTITUTION § 13 (1937).

88. *Donell*, 533 F.3d at 770; *McDermott*, *supra* note 62, at 160.

89. *See* 11 U.S.C. § 548(a) (2006) (outlining a trustee’s permitted avoidances in fraudulent transfer actions).

90. *McDermott*, *supra* note 62, at 160.

91. *Donell*, 533 F.3d at 770; *Scholes*, 56 F.3d at 756.

92. *Donell*, 533 F.3d at 770 (internal quotation mark omitted); *see also* *McDermott*, *supra* note 62, at 160–61 (discussing the ability of a trustee to recover all transferred amounts when pursuing an investor under a theory of actual fraud).

93. *Donell*, 533 F.3d at 771; *see also* 11 U.S.C. § 548(c) (providing that a transferee may enforce an obligation owed if it is grounded in good faith).

a return of her principal investment” only if the good faith standard is met.<sup>94</sup> Since most modern Ponzi schemes are built around the obliviousness of investors, the good faith defense habitually surfaces,<sup>95</sup> eliminating any possibility for the redistribution of principal investments under either theory of fraud and recouping net winners at the expense of those who failed to withdraw sufficient funds before the pyramid collapsed.

#### 4. Additional Channels for Compensation

Outside of clawbacks and the other recovery options thus explained, investors have little additional opportunity to seek relief. One course the Madoff trustee has pursued is that of suing J.P. Morgan Chase, the account holder of the Ponzi funds, for \$6.4 billion, “claiming that the big bank abetted Madoff’s fraud because it ignored red flags about his business.”<sup>96</sup> Any money awarded in such a suit would supplement monies recaptured through the clawback process. This would also be true of money from suits against banks that handled large asset portfolios of Madoff feeder funds. Such suits “accuse the banks of overlooking warning signals . . . [and] of helping sustain the fraud by creating derivative investment products linked to the performance of Madoff feeder funds.”<sup>97</sup> The success of these suits varies, as many come out of desperation and alleged headline grabbing.<sup>98</sup>

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94. McDermott, *supra* note 62, at 167.

95. *See, e.g.*, Warfield v. Byron, 436 F.3d 551, 559–60 (5th Cir. 2006) (addressing one investor’s attempt to argue a good faith defense); Jobin v. McKay (*In re M & L Bus. Mach. Co.*), 84 F.3d 1330, 1337–38 (10th Cir. 1996) (same); Hayes v. Palm Seedlings Partners-A (*In re Agric. Research & Tech. Grp., Inc.*), 916 F.2d 528, 535–36 (9th Cir. 1990) (same); Terry v. June, 432 F. Supp. 2d 635, 641 (W.D. Va. 2006) (same).

96. Zachary A. Goldfarb, *Madoff Investor’s Widow to Return Money*, WASH. POST, Dec. 18, 2010, at A13; *see also* Diana B. Henriques, *Despite Doubts, JPMorgan Kept Ties to Madoff*, N.Y. TIMES, Feb. 4, 2011, at A1 (reporting that JP Morgan allowed Madoff to move billions of dollars in and out of his account right up until the day of his arrest despite expressing serious doubts as to the legitimacy of his operation more than eighteen months before its collapse); Diana B. Henriques, *Madoff Says from Prison That Banks ‘Had to Know’*, N.Y. TIMES, Feb. 16, 2011, at A1 (“[Madoff] spoke with great intensity and fluency about his dealings with various banks and hedge funds, pointing to their ‘willful blindness’ and their failure to examine discrepancies between his regulatory filings and other information available to them. ‘They had to know,’ Mr. Madoff said. ‘But the attitude was sort of, ‘If you’re doing something wrong, we don’t want to know.’” (paragraph break omitted)); John Carney, *How Much Did JP Morgan Make from Madoff Accounts?*, BUS. INSIDER, (Aug. 31, 2009), [http://articles.businessinsider.com/2009-08-31/wall\\_street/30001357\\_1\\_madoff-customers-bernie-madoff-madoff-accounts](http://articles.businessinsider.com/2009-08-31/wall_street/30001357_1_madoff-customers-bernie-madoff-madoff-accounts) (reporting that JP Morgan earned as much as \$483 million in after-tax profits from Madoff’s account).

97. Michael Rothfeld, *The Madoff Fraud: Trustee Sues Kin, Banks for Funds*, WALL ST. J., Dec. 9, 2010, at C1 (discussing the string of lawsuits filed by Picard amounting to \$1.4 billion against Citibank, Merrill Lynch, and others); *see also* Complaint at 2–3, Picard v. Citibank, Adv. Pro. No. 10-05345 (S.D.N.Y. Dec. 8, 2010), *available at* <http://online.wsj.com/public/resources/documents/PicardCitisuit0222.pdf> (docketing Picard’s lawsuit against Citi for \$430 million linked to the bank accepting repayment of a loan from a Madoff feeder fund); Chad Bray, *Global Finance: Madoff Trustee Goes After HSBC*, WALL ST. J., Dec. 6, 2010, at C3 (reporting the suit against HSBC for at least \$9 billion in illicit earnings and damages that came from funneling money to BLMIS despite warnings of the outfit’s suspicious activity); Randall Smith & Matthias Rieker, *Global Finance—The Madoff Fraud: Suit Claims Citi Cut Off Madoff Funds*, WALL ST. J., Feb. 23, 2011, at C3 (describing the aforementioned suit filed by Picard against Citi).

98. *See, e.g.*, Bloomberg News Video, *Madoff Trustee Sues JPMorgan, Claims Bank Aided Fraud*, WASH. POST. (Dec. 3, 2010), *available at* <http://www.washingtonpost.com/wp-dyn/content/video/2010/12/03/>

Similarly, individual investors may sue feeder funds or brokerage firms who funneled money to the Ponzi scheme,<sup>99</sup> since such action represents a failure to conduct due diligence and constitutes a breach of fiduciary duties to clients. Alternatively, in the case of a Ponzi scheme operated within an otherwise legitimate entity, victims may sue the parent company for negligent supervision or related charges.<sup>100</sup> Both of these types of suits, however, are conducted on a case-by-case basis instead of collectively by the trustee. Other than that, people can only hope that either the trustee will succeed beyond expectations,<sup>101</sup> or that net winners will realize the inequity and help rectify the situation peaceably and without the added stress and expense of litigation.<sup>102</sup>

### C. Remedies Thus Explored

#### 1. Net Equity

The many Ponzi schemes that have occurred since the term was originally coined have led courts and trustees to explore various remedies to help investors. All of these remedies end with the allocation of recovered funds, which are apportioned based on each investor's net equity. Expectedly, some investors petition for net equity to be calculated based on the amounts reflected on their fictional statements immediately before the collapse ("Last Statement Method").<sup>103</sup> Courts have consistently rejected this method on the ground that it is unfair to give credence to documentation that was wholly fictional.<sup>104</sup> Instead, courts have preferred to follow the Net Investment Method, which defines net equity as the amount of cash deposited by each customer less any amounts he has already withdrawn.<sup>105</sup>

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VI2010120301871.html (reporting that JPMorgan accused Madoff trustee of "headline grabbing" in response to his recently filed suit).

99. See, e.g., Nathan Becker, *Global Finance: Firm Ordered to Pay \$750,000*, WALL ST. J., Dec. 16, 2010, at C3 (reporting on the result of one such suit).

100. See, e.g., *Visconsi v. Lehman Bros., Inc.*, 244 F. App'x. 708, 710–11, 715 (6th Cir. 2007) (upholding arbitration award of over \$10.4 million against Lehman Brothers for negligent supervision of one of its brokers, who ran a Ponzi scheme).

101. See Michael Rothfeld & Chad Bray, *The Madoff Fraud: Widow to Return \$7.2 Billion*, WALL ST. J., Dec. 18, 2010, at B1 (describing how Picard has reached the \$10 billion plateau and has filed claims amounting to more than \$50 billion, although only roughly \$20 billion was lost in the scheme).

102. See, e.g., Goldfarb, *supra* note 96 (reporting that the wife of recently deceased billionaire Jeffrey Picower pledged to repay the \$7.2 billion, because of the stress from confronting authorities and with the hope that the settlement would ease the suffering of the victims).

103. *In re BLMIS*, 424 B.R. 122, 125 (Bankr. S.D.N.Y. 2010); see also Chad Bray, *Malkovich Seeking More from Madoff*, WALL ST. J., Apr. 2, 2010, at C3 (describing how a trust associated with actor John Malkovich sought to recover \$2.23 million, the alleged value of the trust's fictional securities with BLMIS, compared to the \$670,000 determined by trustee Irving Picard).

104. *In re BLMIS*, 424 B.R. at 141–42 (stating that use of last monthly statements would effectively perpetuate the Ponzi scheme); *U.S. Commodity Futures Trading Comm'n v. Barki, LLC*, No. 3:09 CV 106-MU, 2009 U.S. Dist. LEXIS 112998, at \*3–7 (W.D.N.C. Nov. 12, 2009); *In re Taubman*, 160 B.R. 964, 981–82 (Bankr. S.D. Ohio 1993).

105. *In re BLMIS*, 424 B.R. at 125; see also Securities Investor Protection Act of 1970, 15 U.S.C. § 78III(11) (2006) (defining net equity as it applies to SIPC advances); Sarah N. Lynch, *Madoff Payback Method Gets Support—Investor-Protection Official Will Defend Using Amount Clients Invested Minus Their*

Subsequently, courts classify claimants based on their account histories. Under the Net Investment Method, net winners have zero net equity and therefore no claims.<sup>106</sup> Net losers with net investments over the \$500,000 statutory limit are appropriately named “Over the Limits Net Losers,” have positive net equity, and can claim the amount invested less any withdrawals.<sup>107</sup> Lastly, the “Under the Limits Net Loser receives a SIPC advance against his *pro rata* share of customer property in the amount of his net investment.”<sup>108</sup> Though his account statement “may reflect a balance higher than \$500,000,” the Under the Limits Net Loser is “not entitled to a further distribution from the fund of customer property because [his] Net Equity claims will be fully satisfied by the SIPC advance.”<sup>109</sup> As an example, the trustee in the Madoff Ponzi scheme has filed clawback claims only against net winners.<sup>110</sup>

## 2. Parties Subject To Clawback

Having classified the various parties, the next step is to outline other factors that determine which of them are subject to clawback. One trustee has tailored the extent of clawbacks by considering additional factors, including whether the investor can prove an undue hardship such as losing a house.<sup>111</sup> A more common approach is to identify creditors that had knowledge of the scheme throughout the course of their investments since they are not protected by statute for perpetuation of actual fraud.<sup>112</sup> Almost all creditors found to have been involved in the operation of the fraudulent scheme have been stripped of all payouts, both in principal and alleged interest.<sup>113</sup>

A recent decision, *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*<sup>114</sup> (colloquially known as *Bayou*), discussed the effect of good faith as it relates to clawback of principal given the presence of both actual and constructive fraud.<sup>115</sup> Regarding cases involving constructive fraud, *Bayou* held that the absence of reasonably equivalent value for the transfer represents constructive fraud, which bars application of good faith and permits clawback of fictitious profits.<sup>116</sup> Under actual fraud, *Bayou* and decisions in other circuits have limited clawbacks by

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*Withdrawals*, WALL ST. J., Sept. 23, 2010, at C3 (revealing the SIPC chairman’s support of the Net Investment Method).

106. *In re BLMIS*, 424 B.R. at 132.

107. *Id.*

108. *Id.* An “Under the Limits Net Loser” is a Net Loser with net investments under the \$500,000 statutory limit who subsequently withdrew less than he initially invested in the scheme. *Id.*

109. *Id.*

110. Rothfeld, *supra* note 61.

111. Rothfeld, *supra* note 24.

112. See *supra* note 92 and accompanying text for a discussion of how actual fraudsters are subject to clawback of principal in addition to fictitious profits.

113. See, e.g., *Cuthill v. Greenmark, LLC (In re World Vision Entm’t, Inc.)*, 275 B.R. 641, 658 (Bankr. M.D. Fla. 2002) (“Some recipients, such as insiders directly running the Ponzi scheme, obviously could not demonstrate good faith because of their involvement in the enterprise and their actual knowledge of the fraud.”).

114. 396 B.R. 810 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part sub nom.* *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).

115. *Bayou*, 396 B.R. at 853.

116. *Id.* at 843.

allowing retention of principal if the investor can establish a good faith defense.<sup>117</sup> Although the Bankruptcy Code does not define the term specifically, “federal courts have reached a consensus that ‘good faith’ as used in section 548(c) must be determined according to an ‘objective’ or ‘reasonable person’ standard, and not on the subjective knowledge or belief of the transferee.”<sup>118</sup>

*Bayou* and subsequent commentary have noted various circumstances that indicate a lack of awareness of any fraud, including “redemptions to satisfy specific pre-existing obligations, such as tax liabilities; redemption of substantially less than the entire investment; or redemptions significantly before any ‘red flags’ became evident.”<sup>119</sup> Transitivity, only investors who were actually perpetuating fraud or made withdrawals with quantifiable influence of red flags were subject to clawback of both fictitious profits and principal investments.<sup>120</sup> The exposure of the Madoff fraud has provided the public with examples of red flags beyond actual news of the Ponzi scheme, including “a track record so consistently excellent that it should have raised suspicions; key positions held by members of the Madoff family; a tiny staff considering the scale of the operations; obscure auditors who were not peer-reviewed; feeder funds unable to obtain timely electronic access to their accounts; and so forth.”<sup>121</sup>

Beyond exemptions such as the foregoing examples, the trend across the circuit courts has been to pursue clawbacks exclusively against net winners, and only to the extent of profits.<sup>122</sup> The justification for this approach is that “[f]orcing innocent investors to return funds they contributed to the defunct entity does nothing more than create new victims of the fraud because it deprives those investors of their actual out-of-pocket contributions.”<sup>123</sup> Such inaction allows virtually all net winners to retain their principal investments, though their net loser counterparts are left to only their rations of recovered funds, which can amount to mere pennies for each dollar invested.<sup>124</sup> Courts

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117. *Id.* at 844; Terry v. June, 432 F. Supp. 2d 635, 642 (W.D. Va. 2006).

118. *Bayou*, 396 B.R. at 844 (quoting Omnibus Memorandum of Law of Plaintiffs at 46–51, *Bayou*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008) (No. 06-22306) (citing to extensive case law, including cases analyzing analogous provisions under the Uniform Fraudulent Transfer Act)); see also *Ameriserv Fin. Bank v. Commercebank, N.A.*, No. 07-1159, 2009 U.S. Dist. LEXIS 24559, at \*19 (W.D. Pa. Mar. 26, 2009) (citing *Bayou*, 396 B.R. at 844–45).

119. Doherty et al., *supra* note 49 (discussing the *Bayou* case).

120. See *Bayou*, 396 B.R. at 848–49 (explaining that knowledge of red flags often, but not always, undermines the good faith defense).

121. Wiener, *supra* note 70, at 227 n.28 (citing GREG N. GREGORIOU & FRANÇOIS-SERGE LHABITANT, EDHEC RISK & ASSET MGMT. RESEARCH CTR., MADOFF: A RIOT OF RED FLAGS 10–15 (2009), available at [http://docs.edhec-risk.com/mrk/000000/Press/EDHEC\\_PP\\_Madoff\\_Riot\\_of\\_Red\\_Flags.pdf](http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_PP_Madoff_Riot_of_Red_Flags.pdf)).

122. *Janvey v. Adams*, 588 F.3d 831, 834 (5th Cir. 2009); *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995); *Eby v. Ashley*, 1 F.2d 971, 973 (4th Cir. 1924); *Hecht v. Malvern Preparatory Sch.*, 716 F. Supp. 2d 395, 401 (E.D. Pa. 2010); *Solow v. Reinhardt (In re First Commercial Mgmt. Grp.)*, 279 B.R. 230, 236 (Bankr. N.D. Ill. 2002).

123. Jeffrey G. Hamilton, *Clawback Claims Against Innocent Investors: The SEC vs. the Stanford Receiver*, AM. BANKR. INST. J., Oct. 2009, at 12, 12.

124. Cf. Jane J. Kim et al., *Investors May Have to Surrender Gains*, WALL ST. J., Dec. 15, 2008, at A16 (stating that depending on Madoff investors’ situations, return of profits but not principals may be “mixed news”).

afford this same treatment to principals withdrawn both before and within the reachback period outlined by state law.<sup>125</sup>

One analysis points out that although there are cases in which receivers have brought clawback claims against innocent investors by seeking only fictitious profits, and there are cases in which receivers have successfully recovered an investor's principal investment given a lack of good faith, "no court has ever sanctioned claw back of principal from an innocent investor."<sup>126</sup> Recent attempts by trustees to pursue principals that have been retained by net winners have resulted in strong opposition from the public and the courts.<sup>127</sup> This opposition is largely based on policies of the SEC, which, as a protector of securities investors, "does not want to be seen as being a party to actions that cause hardship to investors who have done nothing wrong."<sup>128</sup>

Amid the various avenues for recovery,<sup>129</sup> the SEC tends to maintain a similar role upon discovery of a Ponzi scheme.<sup>130</sup> By its own words,

The SEC investigates and prosecutes many Ponzi scheme cases each year both to prevent new victims from being harmed and to maximize the recovery of assets to investors. The majority of such cases are brought as emergency actions, which often seek a temporary restraining order and an asset freeze.<sup>131</sup>

Notwithstanding arguments that trustees do not work for the SEC, but rather for the courts that appointed them, SEC policy and its power to file motions tend to strongly influence the litigation process.<sup>132</sup> In line with the trend across the circuits,<sup>133</sup> the SEC recommends that net winners should be subject to clawback only as far as any "returns" on their initial capital outlay.<sup>134</sup>

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125. *Jobin v. McKay* (*In re M & L Bus. Mach. Co.*), 84 F.3d 1330, 1332, 1337–38, 1341 (10th Cir. 1996); *Terry v. June*, 432 F. Supp. 2d 635, 642–43 (W.D. Va. 2006).

126. Brief of Appellees Jim Letsos et al. at 24–25, *SEC v. Stanford Int'l Bank, Ltd.*, 776 F. Supp. 2d 323 (N.D. Tex. 2011) (No. 3-09-CV-0298-N) [hereinafter Brief of Appellees], available at [http://www.stanfordfinancialreceivership.com/documents/879\\_Appendix\\_iso\\_1-3\\_878\\_Objections\\_re\\_Examiner\\_849\\_Fee\\_App\\_Receiver.pdf](http://www.stanfordfinancialreceivership.com/documents/879_Appendix_iso_1-3_878_Objections_re_Examiner_849_Fee_App_Receiver.pdf). *But see* Hamilton, *supra* note 123, at 81 (noting that it is unclear "whether there are any good policy reasons for allowing a receiver to recover principal investments from wholly innocent investors").

127. Hamilton, *supra* note 123, at 81; *see also* Janvey, 588 F.3d at 835 (refusing receiver's motion to freeze net winners' principals).

128. Hamilton, *supra* note 123, at 12.

129. *See supra* notes 42–46 and accompanying text for a discussion of creditors' procedural options in recapturing money.

130. *See* Securities Investor Protection Act of 1970, 15 U.S.C. § 78ggg (2006) (outlining SEC functions given application of SIPA).

131. *Ponzi Schemes—Frequently Asked Questions*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/ponzi.htm> (last visited Mar. 3, 2012).

132. *See* Hamilton, *supra* note 123, at 12 (detailing such influence in an instance where receiver and SEC disagree substantially).

133. *See supra* notes 122–23 and accompanying text for a discussion of the general agreement across the circuit courts to limit clawbacks to net winners' profits.

134. *See* Brief of Appellees, *supra* note 126, at 13 (describing the SEC's motion to deny the receiver's power to pursue principal investments from innocent certificate holders since such action is against SEC policy).

### 3. Distribution

Upon combining the sum of recovered funds acquired through clawback with those recovered through liquidation of the operator's estate, courts determine who is entitled to distribution of the sum and how that distribution should occur. The distribution stage is especially burdensome to investors because, as the *Madoff* court phrased it, "distribution of customer property . . . is a zero-sum game."<sup>135</sup> Of course, net winners who have already been stripped of payouts have no claims.<sup>136</sup> Under the Limits Net Losers are reimbursed via SIPC advance.<sup>137</sup> Therefore, courts typically only allow net losers with net investments in excess of \$500,000 to make claims against the estate.<sup>138</sup>

In terms of how distribution should occur, the default ruling by the courts has been to order a pro rata distribution of the total amount recovered based on the net equity of each investor.<sup>139</sup> "Courts have favored *pro rata* distribution of assets where . . . the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders."<sup>140</sup> The justification for the pro rata standard originates in the Supreme Court opinion surrounding the eponymous name for Ponzi schemes, stating that "equality is equity" between "equally innocent victims."<sup>141</sup> The trustee in the *Madoff* case has already stated his intent to distribute any funds he can recover according to this formula.<sup>142</sup>

The Sixth Circuit has refused the request by net winners that their principal investments be subtracted from the amount they were ordered to disgorge on the ground that hundreds of others victimized by the scheme would recover only forty-two percent of the money they invested, instead of the full principal to which the net

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135. *In re BLMIS*, 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010).

136. See *supra* note 106 and accompanying text for a discussion of how net winners maintain zero net equity.

137. See *supra* notes 108–09 and accompanying text for a discussion of those with net investments under \$500,000.

138. See *supra* note 107 and accompanying text for a discussion of those with net investments over \$500,000.

139. See, e.g., *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002) ("[T]he use of a *pro rata* distribution has been deemed especially appropriate for fraud victims of a 'Ponzi scheme' in which earlier investors' returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity." (citation omitted) (internal quotation marks omitted)); *United States v. 13328 & 13324 State Highway 75 N.*, 89 F.3d 551, 553 (9th Cir. 1996) (finding that departing from pro rata distribution "would frustrate equity"); *United States v. Durham*, 86 F.3d 70, 72–73 (5th Cir. 1996) (affirming distribution of assets seized from a fraudulent scheme pro rata); *SEC v. Elliott*, 953 F.2d 1560, 1570 (11th Cir. 1992) (affirming pro rata distribution since creditors occupied the same legal position as one another); *SEC v. Drucker*, 318 F. Supp. 2d 1205, 1207 (N.D. Ga. 2004) ("[W]here a victim seeking preferential treatment cannot materially distinguish his situation from that of other victims, a pro rata distribution is recognized as the most equitable solution.").

140. *Credit Bancorp*, 290 F.3d at 88–89.

141. *Cunningham v. Brown*, 265 U.S. 1, 13 (1924) (holding that similarly situated fraud victims should share recovered funds equally to prevent inequity). See also *supra* notes 8–9 and accompanying text for a discussion of the exploits of Charles Ponzi.

142. Amir Efrati, *The Madoff Fraud: Judge's Madoff Ruling Bars Recovery for Some Investors*, WALL ST. J., Mar. 2, 2010, at C9.

winner felt they were entitled.<sup>143</sup> The court justified this decision by stating that “[t]he mere coincidence that the [Ponzi schemers] chose the [net winners] (instead of others) to receive funds contributed by other investors in order to delay the discovery of this scheme does not entitle the [net winners] to preferential treatment.”<sup>144</sup> Under similar circumstances, the Fifth Circuit determined that “the facts did not support a remedy that would elevate [the net winners’] claim above the other victims, and accordingly determined that a pro rata distribution would provide a fair and equitable remedy.”<sup>145</sup>

Pro rata distribution is also seen in other fields of the Ponzi scheme recovery process, outside of repaying the recoverable portion of the operator’s estate. In the case with SIPC benefits, courts have ruled that investors in feeder funds are generally only entitled to a pro rata distribution of the fraction of the estate apportioned to the fund.<sup>146</sup> This would mean that a \$10,000 investor in a \$10 million feeder fund would only receive \$500 in SIPC benefits.<sup>147</sup>

While pro rata distribution is the most basic and equitable allocation under classic circumstances, permutations may surface. At least one creative trustee attempted to categorize as gains certain tax benefits net losers were awarded, which would have severely upset normal pro rata distribution, but was ultimately unsuccessful.<sup>148</sup> Other forms of allocation may be explored, but pro rata distribution is generally deemed inapplicable only in special circumstances.<sup>149</sup> Although pro rata distribution is the most frequently used by the courts given its simplicity and the equity it provides amongst victims, such a system is ultimately fruitless if the initial clawback practice it is supposed to complement leads to various levels of inequity.

### III. DISCUSSION

Although some degree of inequity is unavoidable given the nature of a Ponzi scheme, courts seem to consistently implement a virtually uniform remedy instead of applying one that may be more appropriate to the unique facts of each case.<sup>150</sup> The trend across the courts suggests a preference for the Net Investment Method over the

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143. SEC v. George, 426 F.3d 786, 799 (6th Cir. 2005).

144. *Id.*

145. SEC v. Forex Asset Mgmt. LLC, 242 F.3d 325, 331 (5th Cir. 2001).

146. See Doherty et al., *supra* note 49 (reasoning that feeder fund investors will receive only pro rata share of SIPC funds since SIPC covers only feeder funds, not individual investors in feeder funds); *cf.* Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co., 533 F.2d 1314, 1317–18 (2d Cir. 1976) (holding that only feeder funds, not individual investors in feeder funds, are entitled to SIPC funds).

147. See *supra* notes 50–55 and accompanying text for a discussion of SIPC benefits for feeder funds.

148. Soulé v. Alliot (*In re* Tiger Petroleum Co.), 319 B.R. 225, 238–39 (Bankr. N.D. Okla. 2004).

149. See, e.g., SEC v. Black, 163 F.3d 188, 196–97 (3d Cir. 1998) (allowing return of traceable assets to specific investors because they were never pooled or in the control of the defrauder); Anderson v. Stephens, 875 F.2d 76, 80–81 (4th Cir. 1989) (refunding deposits from a frozen account); City of Philadelphia v. Lieberman, 112 F.2d 424, 426 (3d Cir. 1940) (ordering return of assets that had been placed in actual trust account beyond the control of the insolvent party).

150. See *supra* notes 122–23 and accompanying text for a discussion of the universal popularity of clawing back only to the extent of profits.

Last Statement Method in terms of distribution<sup>151</sup> and limiting collection to fictional interest payments without recapturing principal investments, except in the instances where actual fraud is involved.<sup>152</sup> Not surprisingly, this combination, largely based on the collection (clawback) piece, can lead to many innocent investors receiving only pennies for each dollar invested.<sup>153</sup> Although the current collection format may indeed be the most appropriate in many cases, scenarios exist where alternative approaches would provide for a more equitable result. Hence, the current practice of restricting Ponzi scheme collection to the illusory profits of net winners should not be applied uniformly, thus creating the opportunity to clawback principal investments under special circumstances.

The ensuing commentary compares and contrasts the proposed remedy with the commonly implemented approach. Parts III.A and III.B examine the drawbacks and benefits of the current approach, respectively, in light of its strenuous recovery process and relative effectiveness. Part III.C outlines the formula for the proposed remedy as well as its certain advantages over the current approach. Despite these advantages in particular circumstances, Part III.D points out certain obstacles to its implementation and Part III.E explains the alternative remedy's limited reach. Finally, Part III.F puts forth additional considerations in recognition of courts' punishments for Ponzi scheme operators, the government's agenda to protect people from investment fraud, and the public's increased awareness.

#### A. *Problems with the Current Approach*

Among the numerous problems with the current system, perhaps the most apparent is its horrendous inefficiency. Despite the media coverage, government involvement, and enormous sums lost, Madoff trustee Irving Picard had recovered less than five percent of the total money lost at the time of the two-year filing deadline.<sup>154</sup> In the Bennett Funding scheme,<sup>155</sup> the trustee's fraudulent transfer filings amounted to a mere ten percent of the debts, which, in total, exceeded \$1 billion.<sup>156</sup> The court-appointed receiver in the *Stanford* proceedings proposed "to file claims against only 650 of 28,000 Stanford investors and to seek recovery of only \$300 million out of a possible \$2 billion in CD redemptions."<sup>157</sup> Independent of failing to collect from those who are targeted, common reasons that trustees do not even bother pursuing certain

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151. See *supra* note 106 and accompanying text for a discussion of the use of the Net Investment Method.

152. See *supra* notes 112–13 and accompanying text for a discussion of the effect of actual fraud.

153. See *supra* note 124 and accompanying text for further discussion of this point.

154. Van Voris, *supra* note 55; see also Goldfarb, *supra* note 96 (reporting that shortly after the deadline, the wife of recently deceased billionaire Jeffrey Picower pledged to repay the \$7.2 billion that she and her husband withdrew as profits from the Madoff scheme, thus bringing the total amount recovered to almost \$10 billion, which amounts to roughly fifteen percent of the fictional value of the portfolio and twenty-eight percent of its actual value).

155. See generally *In re Bennett Funding Grp., Inc.*, 213 B.R. 227 (Bankr. N.D.N.Y. 1997).

156. McDermott, *supra* note 62, at 158–59.

157. Hamilton, *supra* note 123, at 80.

beneficiaries include jurisdictional barriers, the overwhelming number of investors, and the cost outweighing the benefit for attacking those with smaller portfolios.<sup>158</sup>

The idea of a cost/benefit analysis leads to another component of the inefficiency of the current approach, which is the towering expense associated with a bankruptcy case. Some attorneys often question “whether pursuing these cases is actually in the best interest of the receivership estate, given the costs and potential for recovery.”<sup>159</sup> In the Madoff case, Picard reportedly spent \$26.9 million in six months while recovering only \$849,000 in that time.<sup>160</sup> Not surprisingly, \$15.8 million of those expenses were legal fees to Picard’s law firm.<sup>161</sup> Unlike at least some of the money paid out through the Ponzi scheme, “[t]he substantial legal fees generated by pursuing such claims will not be recovered.”<sup>162</sup> Furthermore, over ninety percent of the money recovered came from payouts within the ninety-day window preceding the bankruptcy filing,<sup>163</sup> which consisted primarily of preference actions that theoretically involve less digging and litigation on behalf of the trustee.<sup>164</sup> Add to that value the court fees for filing thousands of separate lawsuits for each collapse,<sup>165</sup> and the total outlay becomes disproportionate based on the overall goal of the process, which is to compile as much money as possible to distribute to victims.<sup>166</sup>

Another concern with respect to courts is the incredible burden placed on them in regards to the longevity of these suits. In many instances the trustee waits right up until bankruptcy deadlines to file certain lawsuits.<sup>167</sup> Such inaction delays the start date of activity for many investors, who wait in angst and fear at the thought of being robbed of funds they believed to be their property.<sup>168</sup> Even once filed, lawsuits consistently take years to clear from court dockets.<sup>169</sup> The time drained in court translates into increased aggravation and suffering for the blameless victims who, up until the scheme’s collapse, were likely under the impression that they were financially set for

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158. See *id.* at 80–81 (discussing these reasons as they relate to the *Stanford* case).

159. Brubaker, *supra* note 36.

160. Van Voris, *supra* note 55.

161. *Id.*

162. Hamilton, *supra* note 123, at 80.

163. Van Voris, *supra* note 55.

164. See *supra* Part II.B.3.a for a discussion of preference actions versus transfer actions.

165. See, e.g., Hamilton, *supra* note 123, at 80 (describing “substantial legal fees” incurred in filing multiple claims); McDermott, *supra* note 62, at 158–59 (describing the Bennett Funding trustee who filed over 10,000 lawsuits).

166. See *supra* notes 58–62 and accompanying text for a discussion of the role of a bankruptcy trustee.

167. See, e.g., Rothfeld, *supra* note 61 (reporting that Picard filed forty lawsuits just weeks before the two-year fraudulent transfer expiration date).

168. See, e.g., 60 Minutes, *The Liquidator*, CBSNEWS.COM (June 20, 2010), <http://www.cbsnews.com/video/watch/?id=6600767n&tag=mncol:lst;1> (providing video clip of a Madoff investor stating that she checks her mailbox each day in fear of receiving a letter seeking return of funds).

169. See, e.g., *Donell v. Kowell*, 533 F.3d 762, 768 (9th Cir. 2008) (filing judgment more than six years after the SEC’s initial civil action); *Scholes v. Lehmann*, 56 F.3d 750, 752 (7th Cir. 1995) (six years); *Rosenberg v. Collins*, 624 F.2d 659, 662 (5th Cir. 1980) (almost seven years after SEC directed him to stop trading); *United States v. Nooney (In re Diversified Brokers Co.)*, 487 F.2d 355, 355 (8th Cir. 1973) (almost five years); *Conroy v. Shott*, 363 F.2d 90, 91 (6th Cir. 1966) (five years).

the rest of their lives.<sup>170</sup> The aggravation can be so overwhelming that some investors, as a means of avoiding court, respond promptly to clawback notices put forth by the trustee at the outset, either through settlement or by sale of their claims to a third party.<sup>171</sup> Added affliction is not in the best interests of investors and should be avoided at all costs by the trustee.<sup>172</sup>

Apart from inefficiency, another problem with the current approach is the allowance for unjust enrichment. Courts have found that, conceptually, an innocent net winner is only unjustly enriched to the extent of his profits.<sup>173</sup> From a practical perspective, however, the current system of clawbacks appears to do just the opposite of its intent by unjustly enriching the net winners. When viewed individually, it is accurate that retention of principal is not unjust enrichment based on the fact that each investor undeniably enters this process with a claim to bring his net investment to zero.<sup>174</sup> When viewed in the aggregate against net losers, however, it is quite clear that those who happened to pull out are being unjustly enriched at the hands of those who did not.<sup>175</sup> Since no investments are ever made (thus making market trends irrelevant) and good-faith investors whose capital is immunized from this system did not become

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170. See Rothfeld, *supra* note 24 (describing an eighty-seven-year-old woman whose BLMIS statements showed nearly \$3 million in her accounts, but Picard instead demanded her to pay nearly \$700,000 out of her life savings).

171. The process of buying and selling individual claims against a bankrupt debtor, referred to as “claims trading,” proceeds under the theory that “purchasers will acquire claims for a discount from the face amount of the claim” and then make money from “the spread” between the price paid for the claim and a subsequent resale or the resulting distribution. Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1645 (2009). See also Donell, 533 F.3d at 768 (describing a special “one-time offer” sent to at least one investor to settle with the receivership estate for ninety percent of profits distributed); Amir Efrati, *The Madoff Fraud: Trustee Seeking Return of Withdrawn Funds*, WALL ST. J., Apr. 22, 2009, at C13 (describing clawback notices Madoff trustee sent to net winners); Peter Lattman & Diana B. Henriques, *Speculators Are Eager to Bet on Madoff Investors’ Claims*, N.Y. TIMES, Dec. 14, 2010, at A1 (describing one Madoff investor who received at least six offers to purchase rights to his claims for as high as 34.5 cents on the dollar); Michael Rothfeld, *The Madoff Fraud: Fight for Funds Delays Settlement for Madoff Victims*, WALL ST. J., Aug. 4, 2010, at C3 (disclosing that ASM Capital increased their offer on claims to twenty-three percent of their value); Gregory Zuckerman, *The Madoff Fraud: Betting on Madoff Recovery Claims*, WALL ST. J., June 4, 2010, at C1 (“ASM [Capital] is offering either to make an immediate payment of 20% of claims in exchange for the full claim; or make an upfront payment of 16% of the claims, with the investor keeping 33% of future recoveries.”).

172. See *supra* notes 58–62 and accompanying text for a discussion of the role of a bankruptcy trustee.

173. See *supra* Part II.B.3.b for a discussion of bankruptcy rulings regarding unjust enrichment.

174. See *supra* note 83 and accompanying text for a discussion of the notion that each investor has a right to recover at least his net loss.

175. Compare Matthew Futterman & Amir Efrati, *Mets Win One: Owners Made Money on Madoff*, WALL ST. J., Oct. 21, 2009, at C1 (insinuating that despite finishing an astonishing twenty-two games behind the first-place Philadelphia Phillies, the New York Mets Limited Partnership managed to gain a net \$48 million from its Madoff dealings), with Healy, *supra* note 25 (noting that Elie Wiesel and his wife lost their life savings and their charitable foundation suffered a loss of \$15.2 million as a result of investing with Madoff).

aware of any “red flags,”<sup>176</sup> the fact that they pulled out in time was strictly based on luck.<sup>177</sup>

This analysis also connects to other logical and moral quandaries about the current form. Creating a firm rule that all good-faith investors have a right to retain their capital gives credence to the Ponzi scheme and fundamentally treats it as a true investment portfolio. Although the SEC is involved throughout the recovery process, it is important to remember that there never were any securities, CDs, power payments, or any other actual venture in any of these rackets.<sup>178</sup> Courts have consistently denied credibility to Ponzi schemes by effectively ignoring the fictional account values in calculating net equity;<sup>179</sup> why should the approach to clawbacks and distribution function any differently?

*B. Advantages of the Current Approach*

Despite its many pitfalls, the current approach to clawbacks does have certain positive aspects that are unmatched by other options. First, it partially honors the concepts of finality and reliance as it applies to net winners.<sup>180</sup> Reliance involves the “[d]ependence or trust by a person, [especially] when combined with action based on that dependence or trust.”<sup>181</sup> Although the natural inclination is to attribute all sympathy to net losers based on their financial deficiency upon collapse of the Ponzi scheme, it is important not to forget those that were collecting “profits” that they had no reason to treat as anything other than legitimate. One eighty-four-year-old net winner in the Madoff scandal conveyed this belief: “I took what I had every right and reason to believe was my own money.”<sup>182</sup> As a result, these funds may have been given to charities,<sup>183</sup> put towards the purchase of a house,<sup>184</sup> used to save for children’s college expenses,<sup>185</sup> or functioned as the only means of wealth after retirement.<sup>186</sup> To

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176. See *supra* notes 114–21 and accompanying text for a discussion of the *Bayou* case and examples of red flags.

177. See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 67 cmt. f, illus. 16 (2011) (referring to net winners as lucky).

178. See *supra* notes 12–22 and accompanying text for a discussion of Ponzi scheme examples.

179. See *supra* notes 150–52 and accompanying text for a discussion of how net equity is consistently calculated using the Net Investment Method over the Last Statement Method.

180. See *supra* note 39 and accompanying text for a description of how net winner status is determined.

181. BLACK’S LAW DICTIONARY 1404 (9th ed. 2009).

182. Rothfeld, *supra* note 24 (quoting Mike Stein); see also *Johnson v. Studholme*, 619 F. Supp. 1347, 1348 (D. Colo. 1985) (“[T]he defendants simply received payments which appeared to be the very performance which was promised to them when they made their investments in the Fund.”).

183. Healy, *supra* note 25 (explaining how Elie Wiesel’s life savings and charitable foundation were destroyed at the hands of Madoff).

184. Email from Madoff Victim, *supra* note 23 (telling the story of one victim who used money from his BLMIS distributions to purchase a house, which he cannot sell).

185. *Id.* (“My retirement and my son’s college fund[s] [are] all gone.”).

186. *Id.*; see also David B. Caruso, *No Joy for Many Madoff Victims, Despite Settlement*, ASSOCIATED PRESS, Dec. 18, 2010, <http://abcnews.go.com/Business/wireStory?id=12430848> (describing an elderly woman suffering from Alzheimer’s disease and living off interest generated by her Madoff account, but the trustee claims she owes \$3.6 million).

tear into these rightfully executed expense decisions at all is questionable.<sup>187</sup> Therefore, perhaps reaching into the pockets of innocent people to an extent immediately short of capital outlay is as fair of a compromise as courts can justifiably mandate.<sup>188</sup>

Such an approach is also supported by the argument that net winners are innocent of wrongdoing and should not be forced to suffer more than they already have.<sup>189</sup> Although net losers are intuitively worse off than their “winning” counterparts and are indisputably eligible for recovery of some kind in an attempt to make them whole, these claims are against the Ponzi schemer as a debtor, not against fellow creditors.<sup>190</sup> Perhaps this is one of the reasons that years of case law across the circuits also support this approach.<sup>191</sup> Furthermore, it is probably the most practical approach in that it theoretically decreases the total amount of litigation by narrowing the pool of defendants and minimizing opposition.<sup>192</sup>

Another feature of the current system that has allowed it to persist is its widespread applicability. Courts have expressed their confidence with this collection arrangement in the face of numerous permutations incorporating the size of the portfolio, the number of investors, the duration of the operation, and countless other factors.<sup>193</sup> In spite of its flaws, no alternative has proven to have such flexibility. As a

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187. See Official Cattle Contract Holders Comm. v. Commons (*In re Tedlock Cattle Co.*), 552 F.2d 1351, 1352 (9th Cir. 1977) (“Those who took their ‘profits’ and got out are not before us . . . .”); *Abrams v. Eby* (*In re Young*), 294 F. 1, 4 (4th Cir. 1923) (“[T]he balance for distribution is a residuum of the aggregate contribution of all the victims . . . .”); *Johnson*, 619 F. Supp. at 1349–50 (refusing to apply bankruptcy provisions which would otherwise allow receiver to recover fictitious profits).

188. *Donell v. Kowell*, 533 F.3d 762, 776 (9th Cir. 2008) (limiting clawbacks, at maximum, to net profits received within the statute of limitations and distributing recoverable assets among net losers, finding this combination to be most equitable).

189. See Brief of Appellees, *supra* note 126, at 7–8 (discussing court’s refusal to allow receiver to freeze assets amounting to principal, as well as the SEC’s motion restricting receiver’s power to even file clawback claims against principal).

190. *Id.* at 16–21; see also *SEC v. George*, 426 F.3d 786, 798 (6th Cir. 2005) (requiring that a relief defendant not have a legitimate claim to the funds at issue); RESTATEMENT (FIRST) OF RESTITUTION § 13(a) (1937) (“A person who has entered into a transaction with another under such circumstances that, because of a mistake, he would be entitled to restitution from the other . . . is not entitled to restitution from a third person who has received title to or a legal interest in the subject matter either from the other or from the transferor at the direction of the other, and has given value therefor without notice of the circumstances . . . .”).

191. See, e.g., *Donell*, 533 F.3d at 771–72 (noting that investors are permitted to retain initial investment amounts because they have claims against debtor up to that amount); *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995) (explaining that investor is only being asked to return difference between investment he put in at beginning and what he received); *Eby v. Ashley*, 1 F.2d 971, 972–73 (4th Cir. 1924) (stating that equity does not require an innocent investor to pay back amount up to investment amount); *Lawless v. Anderson* (*In re Moore*), 39 B.R. 571, 574–75 (Bankr. M.D. Fla. 1984) (reasoning that by investor retaining initial investment amounts, he is no worse off than he was before giving money to debtor).

192. Based on the model, only net winners are subject to lawsuit, which leaves out those who broke even and net losers who still made out better than they would have under a complete equitable distribution format. See Efrati, *supra* note 171 (describing the notices sent by Picard to net winners).

193. See, e.g., *Janvey v. Adams*, 588 F.3d 831, 834 (5th Cir. 2009) (\$8 billion scheme perpetuated over fifteen years); *Sender v. Nancy Elizabeth R. Heggland Family Trust* (*In re Hedged-Invs. Assocs.*), 48 F.3d 470, 471 (10th Cir. 1995) (\$200 million, 1,636 customers, thirteen years); *Scholes*, 56 F.3d at 752 (\$30 million, two years); *Eby*, 1 F.2d at 971–72 (\$4 million, 5,000 customers, three years); *Hecht v. Malvern Preparatory Sch.*, 716 F. Supp. 2d 395, 396 (E.D. Pa. 2010) (\$78.6 million, 125 customers, thirteen years);

result of the positive aspects of the current approach of prohibiting clawback of principal, courts and the SEC have been reluctant to allow attempts by trustees to demand complete return of principal and interest.<sup>194</sup>

C. *Limited-Application Alternative Remedy: Clawing Back Principal*

Aside from the positive aspects that can be picked out of the current clawback method preferred by courts, it is still unreasonable to create an essentially firm rule that clawing back principal is never an appropriate use of the trustee's power. According to the receiver in the Stanford estate, "the failure to file clawback claims against these innocent investors would unfairly prefer those investors who were lucky enough to redeem their investments before the fraud was discovered."<sup>195</sup> He believes that "all investors, even those investors who redeemed their investments before [the collapse], should share equally in the losses."<sup>196</sup> Although this approach would by no means be appropriate under complex plots such as the Madoff scheme, which spanned over multiple decades and consumed billions of dollars, it is an idea that could be applied under certain conditions.<sup>197</sup>

So, how would this equal collection procedure be accomplished? This is best illustrated by a hypothetical ("Example 1"). A invests \$100 and withdraws \$125, B invests \$200 and withdraws \$50, C invests \$150 and withdraws \$200, D invests \$50 and withdraws nothing. Of the remaining \$125, \$25 remains in the scheme's account while the other \$100 has been squandered by the Ponzi operator and is not recoverable. In sum, total investments amount to \$500, total disbursements amount to \$375, and the value of the liquidated estate equals \$25.

Under the current distribution approach, A and C each return \$25 and \$50, respectively, and break even, therefore bringing the estate up to \$100. B's \$150 in losses equals 75% of the total net losses (B's \$150 + D's \$50 = \$200), whereas D's \$50 loss equals 25%. Accordingly, B would receive \$75 (with the \$50 withdrawal, means 62.5% of total investment recouped) and D would receive \$25 (50% of total investment recouped). Obviously, larger pyramids yield greater discrepancy between investors in terms of the percentage of their investments recouped.

Under the alternative plan, virtually all funds that were ever in the scheme are virtually pooled. In the current example, this amounts to \$400 because of the \$100 in unrecoverable funds squandered by the schemer. Next, each investor's net equity is calculated by his total investment as a proportion of the total value of the Ponzi operation (A=20%, B=40%, C=30%, D=10%). Finally, each person receives their respective percentage of the \$400-recovered estate (A=\$80, B=\$160, C=\$120, D=\$40). In the end, this distribution plan replaces a system of unequal treatment (A=100% of

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Solow v. Reinhardt (*In re* First Commercial Mgmt. Grp.), 279 B.R. 230, 236 (Bankr. N.D. Ill. 2002) (2,000 customers, three years).

194. See, e.g., Brief of Appellees, *supra* note 126, at 7-8 (discussing court's refusal to allow receiver to freeze assets amounting to principal, as well as the SEC's motion restricting receiver's power to even file clawback claims against principal).

195. Hamilton, *supra* note 123, at 80.

196. *Id.*

197. See *infra* Part III.E for a discussion of the limited reach of this alternative remedy.

investment recovered, B=62.5%, C=100%, D=50%) and instead allows each person to recover 80% of their initial payment. The alternative plan exhibits true equal treatment by eliminating the net winner versus net loser opposition and instead unites both groups as victims based on the actuality that money was merely moved around and no investments were ever properly executed.

The alternative remedy of clawing back principal creates the possibility of addressing some of the problems with the current approach.<sup>198</sup> First, it prevents unjust enrichment by precluding certain investors from earning profits off of fictional gambles to the detriment of net losers.<sup>199</sup> Although courts maintain the common belief that “equality is equity,”<sup>200</sup> the proper manifestation of this conclusion necessitates the realization that making some investors whole, though stripping them of profits, constitutes unjust enrichment if others simultaneously receive only pennies on the dollar as victims of the same deception.

The alternative remedy also corrects some of the logical and moral concerns posed by the current approach.<sup>201</sup> The proposed remedy would give absolutely no credence to the current system, and instead would succeed by viewing all participants as identically situated victims and treating them equally under the law. Although ordinary investments are subject to varying degrees of risk, it is important to never forget that despite their advertisement, these were never investment vehicles of any kind. Any redemption by a blind investor was based on a stroke of luck, not intuition or attention to market trends. By completely erasing distributions that were made at the discretion of the swindler, it would be as if there was never allocation of any kind. This would be a more complete materialization of the commonly held conclusion by the courts that “[e]quity does not permit [a net winner’s] zeal to be rewarded.”<sup>202</sup> In theory, the only money lost under this scenario would be money allocated by the schemer for his personal use, and this amount often does not pale in comparison to the amounts in the pockets of investors.<sup>203</sup> In short, the proposition to claw back principal investments reflects the idea that a hospital would rather attend to two patients with paper cuts than one with a stab wound.

#### D. *Obstacles With Proposed Remedy*

As with any proposal, there are obstacles to implementation of this remedy. A primary issue is whether it even fits within the legal framework of the Bankruptcy Code: specifically, whether it would be permitted under existing preference and

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198. See *supra* Part III.A for a discussion of the problems with the current approach.

199. See *supra* Part II.B.3.b for a discussion of unjust enrichment as it applies to Ponzi schemes.

200. *Cunningham v. Brown*, 265 U.S. 1, 13 (1924).

201. See *supra* notes 178–79 and accompanying text for a discussion of these logical and moral quandaries.

202. *Lawless v. Anderson (In re Moore)*, 39 B.R. 571, 575 (Bankr. M.D. Fla. 1984).

203. Compare *Bray*, *supra* note 65 (listing Madoff’s assets, which only amount to between \$823 million and \$826 million), with *HSBC Fights Madoff Claim; New Settlement Reached*, REUTERS (Dec. 6, 2010, 6:34 PM), <http://www.reuters.com/article/2010/12/06/us-madoff-hsbc-idUSTRE6B509Q20101206> (describing Picard’s quest to locate as much as \$36 billion).

fraudulent conveyance provisions.<sup>204</sup> The fraudulent transfer provision permits a bankruptcy trustee to avoid any transfer in which the debtor had an actual intent to defraud other creditors.<sup>205</sup> On the one hand, payments do not mathematically begin to defraud other investors in the scheme until they exceed a recipient's principal.<sup>206</sup> On the other hand, however, all distributions by a Ponzi scheme operator theoretically involve such intent by default.<sup>207</sup>

There is other legal foundation for this idea, as well. In a second hypothetical ("Example 2"):

"A [the fraudster] wrongfully takes \$5000 belonging to B and deposits it in a bank. A draws out and dissipates \$2000. A deposits \$5000 belonging to C in the same account. A draws out and dissipates \$4000. Of the balance of \$4000 B is entitled to three-eighths or \$1500, and C is entitled to five-eighths or \$2500."<sup>208</sup>

Now take a third hypothetical ("Example 3"), where the facts are identical to those of Example 2, "except that A subsequently deposits \$5000 belonging to D, and subsequently draws out and dissipates \$4500. Of the balance of \$4500 B is entitled to three-eighteenths or \$750, C is entitled to five-eighteenths or \$1250, and D is entitled to ten-eighteenths or \$2500."<sup>209</sup> Although the outcomes of these scenarios are largely based on tracing and other areas of the law, they illustrate the point that certain investors cannot "throw" their losses unto other investors simply because the former lost more proportionally.<sup>210</sup> Likewise, net winners in a Ponzi scheme should not be automatically entitled to disguise their losses as profits by "throwing" their withdrawals on co-clients who suffered a net loss.

One reason that this remedy has not yet been explored and would likely run into large obstacles before implementation is the lack of support by the SEC. The SEC has stated its opinion that pursuing clawback claims against innocent investors "contravenes Commission practice and is supported by neither logic nor the law."<sup>211</sup> Regarding its policy argument, the SEC "does not want to be seen as being a party to actions that cause hardship to investors who have done nothing wrong."<sup>212</sup> The general SEC rationale has been that "[f]orcing innocent investors to return funds they contributed to the defunct entity does nothing more than create new victims of the fraud

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204. See *supra* Part II.B.3.a for a discussion of existing preference and fraudulent conveyance provisions.

205. 11 U.S.C. § 548(a)(1)(A) (2006).

206. See *supra* note 83 and accompanying text for a discussion of how each defrauded investor has a claim in restitution to recover at least the amount of his net loss.

207. See *supra* note 92 and accompanying text for a discussion of actual fraud being presumed in a Ponzi scheme.

208. RESTATEMENT (FIRST) OF RESTITUTION § 213 cmt. c, illus. 5 (1937); see also *In re* Walter J. Schmidt & Co., 298 F. 314, 316 (S.D.N.Y. 1923) (Judge Learned Hand outlining similar scenarios); 1 GEORGE E. PALMER, THE LAW OF RESTITUTION 216 (1st ed. 1978) (outlining similar scenarios).

209. RESTATEMENT (FIRST) OF RESTITUTION § 213 cmt. c, illus. 6; see also *In re* Walter J. Schmidt & Co., 298 F. at 316 (outlining similar scenarios); PALMER, *supra* note 208, at 216 (same).

210. *In re* Walter J. Schmidt & Co., 298 F. at 316; PALMER, *supra* note 208, at 216.

211. Hamilton, *supra* note 123, at 12.

212. *Id.*

because it deprives those investors of their actual out-of-pocket contributions.”<sup>213</sup> These policy arguments are of considerable magnitude based on the idea “that a receiver, when performing his or her duties, should owe some degree of deference to the SEC’s established policies.”<sup>214</sup>

As for the SEC’s second argument, that clawing back principal lacks legal merit, this is largely based on the first reason; those in charge of recovering funds often avoid principal clawbacks because it is against SEC policy.<sup>215</sup> In other words, “receivers have brought clawback claims against innocent investors and there are cases in which receivers have successfully recovered an investor’s principal investment. What is absent, however, are cases in which a receiver has clawed back the principal investment from an innocent investor.”<sup>216</sup> Although the SEC appoints receivers, such as in the Stanford case, whereas the SIPC is responsible for the appointment of trustees such as Picard in the Madoff case, the aforementioned policies and partiality for limiting clawbacks to profits are generally endorsed by both of these entities.<sup>217</sup>

Apart from a shortage of legal and SEC support, another key obstacle against implementation of this proposed remedy is that it does not correct many of the problems with the current approach.<sup>218</sup> Perhaps most apparent is that the proposal at hand does not make the recovery process any more efficient and, in fact, could have the opposite effect under certain circumstances.<sup>219</sup> In large schemes that span over many years and involve thousands of creditors, the proposed process would undoubtedly invite more individual lawsuits.<sup>220</sup> More lawsuits translate into more people bothered by litigation,<sup>221</sup> more money wasted,<sup>222</sup> and more time spent in court.<sup>223</sup> This idea is compounded by the fact that under the present approach, many net winners do their best to avoid the agony of litigation by either willingly accepting discounted offers by the trustee or selling their claims to third parties.<sup>224</sup> It is safe to assume that far fewer of these acquiescing beneficiaries would be as open to clawback of their principal investment as well. This unearths another key obstacle with the proposed remedy, which is the fear of outcry. One would not need to look any further than the Madoff

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213. *Id.*

214. *Id.* at 81.

215. *Id.*

216. *Id.*

217. *See id.* (indicating that the Picard approach to clawbacks is more in line with SEC practice than the Stanford receiver’s petition).

218. *See supra* Part III.A for a discussion of the problems with the current approach.

219. *See* Hamilton, *supra* note 123, at 81 (“Such an outcome would be devastating for an estate that has already been largely exhausted by the legal and other professional fees . . .”).

220. *See, e.g., In re* Bennett Funding Grp., Inc., 213 B.R. 227, 230 (Bankr. N.D.N.Y. 1997) (involving more than \$1 billion owed to 12,000 customers, 10,000 of which had clawback suits filed against them).

221. *See supra* note 157 and accompanying text for a discussion of how only 650 of the 28,000 Stanford investors are being bothered with clawback suits.

222. *See supra* notes 159–66 and accompanying text for a discussion of legal fees and other expenses associated with Ponzi scheme litigation.

223. *See supra* note 169 and accompanying text for a discussion of how long Ponzi schemes can take to clear court dockets.

224. *See supra* note 171 and accompanying text for a discussion of offers put forth by the trustee and third parties.

and Stanford cases to discover that the clawback of profits has been met with notable opposition.<sup>225</sup> In sum, the addition of principal to the clawback framework would create unfathomable protest.

Despite correcting some of the aforementioned logical and moral issues,<sup>226</sup> the alternative remedy also reverses some of the benefits of the current approach. Namely, this option does not honor finality or reliance.<sup>227</sup> Though the current system is not perfect in this regard either because it does not afford finality protection to all profits,<sup>228</sup> it allows net winners to at least rely on the disbursement of the principal, which the alternative remedy would not. Furthermore, one could argue that this option effectively creates new victims by depriving everyone of their out-of-pocket contributions.<sup>229</sup> Failure to correct various problems with the current approach and the overall lack of support may explain why the proposed remedy has not already been attempted.

#### E. *Limited Reach of the Alternative Remedy*

In light of these obstacles to the proposal to claw back capital contributions by Ponzi scheme investors, it is important to keep in mind that this alternative remedy has very limited applicability. Expectedly, there are instances where clawing back principal would not be appropriate. Extensive schemes that endure over many years, like that of Madoff,<sup>230</sup> are far too complex for the alternative remedy to apply. First, there are far too many investors, which transforms a litigation framework that is already sufficiently confusing and overwhelming<sup>231</sup> into one that is so daunting as to be unmanageable. Second, net losers and net winners alike rely exponentially on their withdrawals with each additional day the scheme persists. Disbursed funds become difficult or impossible to recover once they have been put towards education,<sup>232</sup> donated to charity,<sup>233</sup> or otherwise spent by the oblivious customer.

Despite the duration and volume of publicized schemes such as those of Madoff and Stanford, the reality is that most Ponzi schemes tend to last less than one year.<sup>234</sup> Shorter and smaller schemes amount to fewer investors, even fewer lawsuits, and,

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225. See *supra* notes 127–28 and accompanying text for a discussion of opposition to this system put forth by the courts, the public, and the SEC.

226. See *supra* notes 178–79 and accompanying text for a discussion of the logical and moral quandaries associated with the current form.

227. See *supra* notes 180–88 for a discussion of how finality and reliance are honored by the current approach.

228. See *supra* Part II.B.3 for a discussion of the current clawback approach.

229. See *supra* note 123 and accompanying text for a discussion of this notion.

230. See *In re BLMIS*, 424 B.R. 122, 126–32 (Bankr. S.D.N.Y. 2010) (describing the Madoff fraud, which may have lasted as long as forty years).

231. See *supra* note 193 for a list of cases demonstrating the complexity of schemes involving numerous investors, long duration, and high-value portfolios.

232. See, e.g., Email from Madoff Victim, *supra* note 23 (“My retirement and my son’s college fund[s] [are] all gone.”).

233. See, e.g., Healy, *supra* note 25 (noting that Elie Wiesel and his wife lost their life savings and their charitable foundation suffered a loss of \$15.2 million as a result of investing with Madoff).

234. Catherine Rampell, *A Scheme with No Off Button*, N.Y. TIMES, Dec. 21, 2008, at WK5.

theoretically, less detrimental reliance. Under the right circumstances, these more manageable operations present an opportunity for the alternative remedy involving clawback of principal. Recall Example 1,<sup>235</sup> which involved only four investors; it was relatively simple to distribute pro rata based on the retrieval of principal. If the scheme was sufficiently short-lived that there was limited reliance by early investors, clawing back principal would be a reasonable and viable proposition.

Another consideration in analyzing the limited reach of this proposal is that of investment timing. Under the alternative formula,<sup>236</sup> there is no clawback leniency afforded to the innocent customer who invests chronologically closer to the scheme's collapse, having had no change in the value of his portfolio. A final hypothetical ("Example 4") modifies Example 1 by adding a chronology: A invests \$100 in 2004 and withdraws \$125 by the time the scheme collapses in 2011; B invests \$200 in 2007 and withdraws \$50; C invests \$150 in 2008 and withdraws \$200; D invests \$50 in 2009 and withdraws nothing. Of the remaining \$125, \$25 remains in the scheme's account while the other \$100 has been squandered by the Ponzi operator and is not recoverable. In sum, total investments amount to \$500, total disbursements amount to \$375, and the value of the liquidated estate equals \$25. Recall that under the alternative plan, each investor would receive 80% of his total investment.<sup>237</sup> As such, customers A and D are deprived of the same 20% of their respective principals, although theoretically D's investment was less substantial in funding the scheme.

Unfortunately, even schemes that are short-lived have the potential to devastate large groups of people.<sup>238</sup> Hence, the proposal to claw back principal cannot be widely applied. In fact, it would not even support the purpose of this Comment to outline specific parameters—based on number of investors, size of the portfolio, or length of the scheme—as to when it is preferred over the current remedy. This Comment exists only as a means of bringing to light a remedy that has yet to be explored. The intention behind this Comment is not to reverse nearly a century of case law and blindly demand a solution that is flawless and can be applied universally. In spite of its limited applicability, this alternative should not be so promptly rejected by the courts, since it has the capability of providing equitable relief.<sup>239</sup>

#### F. *Additional Considerations*

As Ponzi schemes have persisted over the years and have become more complex and tragic, additional considerations continue to surface. The tax field accounts for at least one supplement to the remedial process and has gained popularity in the recent string of Ponzi schemes given the ineffectiveness of ordinary recovery. In the Madoff

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235. See *supra* Part III.C for an analysis of Example 1.

236. See *supra* Part III.C for a discussion of the technical aspects of the alternative remedy.

237. See *supra* Part III.C for an application of the alternative remedy to Example 1. Also, this assumes a reachback period of two years, as outlined in 11 U.S.C. § 548(a)(1) (2006).

238. See, e.g., *Cunningham v. Brown*, 265 U.S. 1, 7–9 (1924) (describing the eponymous Ponzi scheme, which lasted under a year but resulted in the loss of millions of dollars from thousands of investors).

239. See *supra* Part III.C for a discussion of how the alternative remedy can provide all investors with a majority refund of their investment instead of creating a discrepancy that allows some to recover entirely at the expense of their peers.

case, unique tax breaks might allow certain investors to recover as much as forty percent of their losses, which will constitute the bulk of the compensation effort and is a substantial improvement from depending on the clawback process alone.<sup>240</sup> In fact, the Internal Revenue Service (IRS) has shown signs of fighting the effects of investment fraud as Ponzi schemes and similar operations have become more elaborate and have inflicted more severe damage.<sup>241</sup> Victims can also seek relief through other government organizations including the Social Security Administration, which can provide a reduction to certain Medicare premiums.<sup>242</sup>

Notwithstanding these fresh opportunities, the conventional restorative technique, and the limited-reach proposed alternative, the best way to defeat the Ponzi scheme enemy is to prevent its growth from the onset. As the *Bayou* case points out, investors should be on notice of certain “red flags” which may suggest fraudulent activity.<sup>243</sup> In the Madoff case, these “red flags” included, but were not limited to, “a track record so consistently excellent that it should have raised suspicions; key positions held by members of the Madoff family; a tiny staff considering the scale of the operations; obscure auditors who were not peer-reviewed; feeder funds unable to obtain timely electronic access to their accounts; and so forth.”<sup>244</sup>

Even without the benefit of hindsight, journalists and industry experts were suspicious of Madoff’s operation long before its collapse because of his refusal to disclose any specifics<sup>245</sup> and the secrecy he commanded from his investors.<sup>246</sup> (Disappointingly, the SEC ignored at least one analyst who repeatedly warned of

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240. Jane J. Kim, *The Madoff Fraud: News Gets a Bit Better for Victims of Madoff*, WALL ST. J., Dec. 9, 2009, at C1; see also *Soulé v. Alliot (In re Tiger Petroleum Co.)*, 319 B.R. 225, 238–39 (Bankr. N.D. Okla. 2004) (rejecting the trustee’s attempt to categorize as gains certain tax benefits net losers were awarded); Rev. Rul. 2009-9, 2009-1 C.B. 735 (permitting an investor to categorize funds lost in a Ponzi scheme as deductible theft losses).

241. John D. McKinnon & Jane J. Kim, *U.S. News: Ponzi Scheme Victims Get a Tax Break*, WALL ST. J., Mar. 18, 2009, at A4 (reporting the IRS announcement that many of those affected by the Madoff fraud could deduct an unprecedented ninety-five percent of their losses immediately, breaking away from longstanding tax relief limits historically afforded to investment scam victims). For a negative criticism of the IRS’s response to the Madoff victims, see Kip Dellinger, *IRS Abuse of Madoff Victims*, 129 TAX NOTES 1261 (2010) (“The IRS responded by issuing Revenue Ruling 2009-9, which provides legal authority and analysis enabling individuals to claim as theft loss deductions (eligible for a three-, four-, or five-year carryback) the losses they sustained both as to unrecovered investments in the scheme and previously reported ‘phantom profits’ that were reinvested in the scheme and not withdrawn when it unraveled.”).

242. See Kelly Greene, *Madoff Victims Can Get Medicare Premium Relief*, WALL ST. J., June 20, 2009, at B2 (“As of June 9, Medicare beneficiaries who are alleged victims of Bernard Madoff’s Ponzi fraud may be able to get their Part B premiums reduced, according to Mark Lassiter, a spokesman for the Social Security Administration in Baltimore.”).

243. *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 853 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part sub nom. Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).

244. Wiener, *supra* note 70, at 227 n.28 (citing GREG N. GREGORIOU & FRANÇOIS-SERGE LHABITANT, EDHEC RISK & ASSET MGMT. RESEARCH CTR., MADOFF: A RIOT OF RED FLAGS 10–15 (2009), available at [http://docs.edhec-risk.com/mrk/000000/Press/EDHEC\\_PP\\_Madoff\\_Riot\\_of\\_Red\\_Flags.pdf](http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_PP_Madoff_Riot_of_Red_Flags.pdf)).

245. See Arvedlund, *supra* note 16, at 26 (“It’s a proprietary strategy. I can’t go into it in great detail.”).

246. *Id.* (“If you invest with me, you must never tell anyone that you’re invested with me. It’s no one’s business what goes on here.”).

Madoff's fraud.<sup>247</sup>) Nevertheless, the SEC has published its own list of ways to avoid Ponzi schemes and other instances of affinity fraud, which includes performing due diligence instead of relying solely on a recommendation and being skeptical of investment opportunities that are not in writing, rush you to purchase, are based on "inside" information, or "promise spectacular profits or 'guaranteed' returns."<sup>248</sup> "If an investment seems too good to be true, then it probably is."<sup>249</sup> Ponzi schemes rely on the confidence and greed of the public; without financing, it is impossible for them to evolve and ultimately devastate any investors.

#### IV. CONCLUSION

Ponzi schemes are acts of catastrophic selfishness that are doomed from the start and indubitably end in tragedy for everyone involved.<sup>250</sup> Often the damage inflicted is so grave that it can never be undone.<sup>251</sup> Still, gathering the withdrawals made by fellow investors often represents the best attempt at making others whole.<sup>252</sup> The trustee is left with the daunting task of clawing back disbursements from the Ponzi operation.<sup>253</sup>

The widely accepted approach to limit these clawbacks to profits has garnered only marginal success and is inconsistent given the spectrum of the schemes in terms of size and duration.<sup>254</sup> Although there is no uniform solution, the idea of subjecting principal investments to clawback may have limited application and is worthy of exploration.<sup>255</sup> In light of certain obstacles to its implementation,<sup>256</sup> this remedy would have only limited reach, constrained by a scheme's chronology, number of investors, and overall portfolio volume.<sup>257</sup> In short, it is unrealistic to accept the current practice of applying one remedy across the board, since such a practice ignores the truth that each of these horrific cases has unique facts that deserve individual attention.

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247. Allan Chernoff, Sr., *Madoff Whistleblower Blasts SEC*, CNNMONEY (Feb. 4, 2009, 1:29 PM), [http://money.cnn.com/2009/02/04/news/newsmakers/madoff\\_whistleblower/index.htm](http://money.cnn.com/2009/02/04/news/newsmakers/madoff_whistleblower/index.htm).

248. *Affinity Fraud*, *supra* note 31.

249. *Id.*

250. See *supra* Part II.A for a discussion of the many forms of Ponzi schemes and their common result.

251. See *supra* notes 23–27 and accompanying text for examples of the tragedies suffered by Ponzi scheme victims.

252. See *supra* notes 5–6 and accompanying text for a discussion of how this startling realization eventually supersedes the commonly held "pot of gold" illusion.

253. See *supra* Part II.B.3 for a discussion of the clawback process.

254. See *supra* Part III.A for a discussion of problems with the current approach.

255. See *supra* Part III.C for a discussion of the proposed alternative remedy to extend clawbacks beyond distributions amounting to profits.

256. See *supra* Part III.D for a discussion of obstacles to the proposed alternative remedy.

257. See *supra* Part III.E for a discussion of the limited reach of the alternative remedy.

