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Cover Page Footnote

Tally M. Wiener has served as law clerk to federal judges at the trial and appellate levels. She practices law in New York where the focus of her work has been resolution of complex issues arising in Mega Chapter 11 proceedings. She has also served as mediator and as counsel to mediators and parties to mediations. After writing this Essay, the author joined Brown Rudnick LLP's Bankruptcy and Corporate Restructuring Group. The views expressed in this Essay are solely her own. The author welcomes questions and comments and is reachable at TallyWiener@yahoo.com.

ESSAYS

ON THE CLAWBACKS IN THE MADOFF LIQUIDATION PROCEEDING

*Tally M. Wiener**

At a Meeting of Creditors held on February 20, 2009, counsel for the trustee overseeing the liquidation of Bernard L. Madoff Investment Securities, LLC, announced the advent of "clawback" suits seeking to recover sums paid out to defrauded investors.[1] This Essay explains the legal framework for the clawback suits and anticipates that many investors in the Ponzi scheme[2] will not have submitted claims by the

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1. *See* Diana B. Henriques, *Madoff Never Made Supposed Investments*, N.Y. TIMES, Feb. 20, 2009, at B1. The video recording of the Meeting of Creditors was posted to www.madofftrustee.com, where it was publicly available. However, it was subsequently removed. Readers interested in watching the recording can contact the trustee at (888) 727-8695. *See* Bernard L. Madoff Investment Securities, LLC Liquidation Proceeding, http://www.madofftrustee.com/ (visited June 15, 2009).

2. A "Ponzi" scheme is a term generally used to describe an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The person who runs this scheme typically uses some of the money invested for personal use. Usually this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments. *In re* Randy, 189 B.R. 425, 437 n.17 (Bankr. N.D. Ill. 1995). *See* Robert Frank & Amir Efrati, *'Evil' Madoff Gets 150 Years in Epic Fraud: Victims Cheer Tough Sentence: Judge Slams Financier for Stonewalling Investigators: True Size of Losses Still a Mystery*, WALL ST. J., June 30, 2009, at A1; David Gardner, *Victims Rejoice as Madoff Is Hauled to Prison*, DAILY MAIL (LONDON), Mar. 13, 2009,

July 2, 2009 deadline, which may result in clawback litigation before multiple courts. The Essay then discusses ways to streamline clawbacks and other Madoff-related litigation so that investors who have already been defrauded are not further damaged by the measures taken to compensate them. It closes with an invitation for additional proposals.

I. CLAWBACKS IN THE MADOFF LIQUIDATION PROCEEDING: AN OVERVIEW

While the liquidation proceeding of Bernard L. Madoff Investment Securities, LLC is pending before the Bankruptcy Court,[3] it is not a proceeding under the Bankruptcy Code.[4] It is a proceeding under the Securities Investor Protection Act of 1970, as amended ("SIPA").[5] On December 15, 2008, the United States District Court for the Southern District of New York appointed Irving Piccard to serve as the SIPA trustee and transferred the SIPA proceeding to the Bankruptcy Court.[6]

A SIPA trustee can bring avoidance actions, colloquially referred to as "clawbacks," pursuant to the preference and fraudulent transfer

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at 32.

3. *See* SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Pro. No. 08-01789 (BRL), 2009 Bankr. LEXIS 446 (Bankr. S.D.N.Y. Feb. 24, 2009).

4. *See* 11 U.S.C. § 101 (2006 & 2007 Supp.).

5. The purposes of a liquidation proceeding under this chapter shall be—
(1) as promptly as possible after the appointment of a trustee in such liquidation proceeding, and in accordance with the provisions of this chapter—
(A) to deliver customer name securities to or on behalf of the customers of the debtor entitled thereto as provided in section 78fff-2(c)(2) of this title; and
(B) to distribute customer property and (in advance thereof or concurrently therewith) otherwise satisfy net equity claims of customers to the extent provided in this section;
(2) to sell or transfer offices and other productive units of the business of the debtor;
(3) to enforce rights of subrogation as provided in this chapter; and
(4) to liquidate the business of the debtor.
15 U.S.C. § 78aaa (1970) (as amended).

6. *See* Application of the Securities Investor Protection Corp. at ¶¶ II & IX, SEC v. Bernard L. Madoff v. Bernard L. Madoff Inv. Sec. LLC, No. Civ. 08-10791, 2008 U.S. Dist. Ct. Motions LEXIS 65573, at **6, 12 (S.D.N.Y. Dec. 15, 2008); *see also* 15 U.S.C. § 78eee(b)(4) (2006) ("Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, under this section, the court shall forthwith order the removal of the entire liquidation proceeding to the court of the United States in the same judicial district having jurisdiction over cases under Title 11. The latter court shall thereupon have all of the jurisdiction, powers, and duties conferred by this chapter upon the court to which application for the issuance of the protective decree was made.").

provisions of the Bankruptcy Code.[7] Preference actions and fraudulent transfer actions can reach both payments of fictitious profits and withdrawals of principal.[8] On April 8, 2009, the trustee filed the first clawback action against investors in the Ponzi scheme.[9]

A. Avoidance of Preferences

Through a preference action, the trustee can seek to recover transfers (including transfers of money) made while Bernard L. Madoff Investment Securities, LLC was insolvent, on or within the 90 days before the December 11, 2008 commencement of the SIPA proceedings (or in the case of transfers to an insider, within a year) provided that the transfers were made to or for the benefit of a creditor and for or on account of an antecedent debt, and allowed the targeted creditor to receive more than it would have received in a hypothetical chapter 7 liquidation.[10] As one of the leading treatises on bankruptcy explains:

> [P]reference law reaches back over a defined period prior to bankruptcy and restructures transactions so as to level out the overall

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7. 15 U.S.C. § 78fff-1(a) (1970) (as amended) ("A [SIPA] trustee shall be vested with the same powers and title with respect to the debtor and property of the debtor, including the same right to avoid preferences, as a trustee in a case under Title 11."). For an excellent discussion of clawback actions under the Bankruptcy Code in the context of Ponzi schemes, see Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998). The term "clawback" made headlines in early 2009 in an entirely different context when insurance giant AIG paid out $165 million in employee bonuses after receiving government bailout money. President Obama responded by ordering the Treasury Secretary to pursue ways to cancel the bonuses. *See, e.g.*, Colin Barr, *Clawbacks Can't Scratch AIG: Washington Wants to Tax AIG Bonuses into Submission. So Much for Provisions Meant to Protect Taxpayers from Excessive Compensation in the First Place*, CNN MONEY, Mar. 18, 2009, http://money.cnn.com/2009/03/17/news/aig.bonusgate.fortune/index.htm.

8. A more detailed discussion of the elements of and defenses to actions seeking the return of preferential payments and fraudulent transfers than the one that follows is beyond the scope of this essay. *See generally* Hon. William H. Brown et al., *Advanced Issues in Avoidance*, *in* 2007 NORTON BANKRUPTCY LAW SEMINAR MATERIALS (2007); McDermott, *supra* note 7.

9. *See In re* Bernard L. Madoff Inv. Sec. LLC, Nos. 09AP01154, 08-01789 (BRL), 2008 WL 5980300 (Bankr. S.D.N.Y Apr. 9, 2008); Amir Efrati, *Madoff Trustee Sues Investors to Recover Funds*, WALL ST. J., Apr. 10, 2009, at C1.

10. *See* 11 U.S.C. § 547(b) (2006 & 2007 Supp.); *see also id.* §§ 547(c) (setting forth preference defenses), 547(f) (creating a presumption of insolvency).

> treatment received by similar creditors. This does not imply that the prepetition transfers avoided to accomplish this leveling were immoral or improper when made. Rather, they are avoided because their effect contravenes bankruptcy law concepts as to the economic effects sought in a distribution of assets or income.[11]

The most commonly invoked defenses are that the challenged transfer was made in the "ordinary course of business"[12] or the recipient gave "new value" after the challenged transfer was made.[13] The Bankruptcy Code sets out the ordinary course of business defense and excepts from avoidance:

> [T]ransfer[s]...in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee [if the] transfer[s were] –
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
> (B) made according to ordinary business terms.[14]

It remains to be determined how the ordinary course of business defense will be applied in the context of a cash-in, cash-out Ponzi scheme, in which debts were incurred as part of an extraordinary and unlawful enterprise and payments came from other people's money. More straightforward, although also likely to be controversial in high-stakes preference litigation, is the "new value" defense. Under Section 547(c)(4) of the Bankruptcy Code, a recipient of a challenged transfer must show that "(i) the debtor received new value after the transfer, and (ii) such new value remained unpaid" to establish a new value defense.[15] New value, even in the context of the complex Madoff SIPA proceedings, may simply be a new investment.[16]

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11. 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON, III, NORTON BANKRUPTCY LAW AND PRACTICE § 66:1 (3d ed. 2009).

12. *See* 11 U.S.C. § 547(c)(2) (2006 & 2007 Supp.).

13. *Id.* § 547(c)(4).

14. *Id.* § 547(c)(2). *See generally* 4 NORTON & NORTON, *supra* note 11, at § 66:19 (discussing the ordinary course of business defense).

15. *In re* Pameco Corp., 356 B.R. 327, 341 (Bankr. S.D.N.Y. 2006) (citing *In re* Teligent, Inc., 315 B.R. 308, 315 (Bankr. S.D.N.Y. 2004)).

16. *See* 11 U.S.C. § 547(a)(2) (2006 & 2007 Supp.) ("'[N]ew value' means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing

B. Avoidance of Fraudulent Transfers

Through a fraudulent transfer action, a trustee can undo both (1) actual fraudulent transfers - transfers (including transfers of money) and obligations made with actual intent to hinder, delay or defraud creditors and (2) constructive fraudulent transfers - transfers and obligations for which less than reasonably equivalent value was received at a time when the debtor was or would soon be insolvent.[17]

The reachback period under 11 U.S.C. § 548(a) of the Bankruptcy Code is two years.[18] The trustee can also invoke state law to recover fraudulent conveyances.[19] Under New York law, the statute of limitations for fraudulent conveyance claims is six years.[20] As one of the leading casebooks on bankruptcy law explains: "The purpose of fraudulent conveyance law, whatever its form, is simple: it protects a debtor's unsecured creditors from reductions in the debtor's estate to which they look, generally, for their security."[21]

A defendant can retain challenged transfers if it can prove it gave "value" and acted in "good faith."[22] 11 U.S.C. § 548's definition of "value" is fairly intuitive and covers money put into the Ponzi scheme by investors: "'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the

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obligation.").

17. *See id.* § 548(a).

18. *See id.*

19. *See id.* § 544(b).

20. *See* N.Y. C.P.L.R. § 213(8) (McKinney 2009) ("[T]he time within which [an] action [based upon fraud] must be commenced shall be the greater of six years from the date the cause of action accrued or two years from the time the plaintiff or the person under whom the plaintiff claims discovered the fraud, or could with reasonable diligence have discovered it."); *In re* Borriello, 329 B.R. 367, 372 (Bankr. E.D.N.Y. 2005) ("An action under New York law to set aside a fraudulent conveyance is governed by the six-year statute of limitations for actions grounded in fraud, commencing at the time of the conveyance.") (citing Island Holding, LLC v. O'Brien, 6 A.D.3d 498, 499-500 (N.Y. App. Div. 2004)). New York State law is cited by way of example of a state law on fraudulent conveyances. For a discussion of application of choice of law principles to fraudulent conveyance actions, see, for example, *Drenis v. Haligiannis*, 452 F. Supp. 2d 418 (S.D.N.Y. 2006).

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

22. 11 U.S.C. § 548(c) (2006 & 2007 Supp.).

debtor."[23] "Good faith" is a more elusive concept. It is not defined by § 548, but rather, has been construed by case law.

Many believe that a ruling on clawback issues in the bankruptcy proceedings of *Bayou Group, LLC*[24] is instructive.[25] In *Bayou*, the Bankruptcy Court held that defrauded investors had to disgorge fictitious profits and could keep withdrawals of principal, but only to the extent that they could prove that they did not make the withdrawals after becoming aware of "red flags."[26] The Court explained:

> [A]ny rational investor or financial advisor, on inquiry notice of a warning signal respecting an investment, would be entirely justified in requesting or recommending redemption and could not be criticized for doing so. Indeed, it would be quite reasonable for an investor to decide to redeem solely on the basis of the red flag without making any inquiry, since the investor has no obligation to any third party to make any inquiry. But if he does so, the courts have held that he cannot invoke the good faith defense under Section 548(c).
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> The rule does not require that the "red flag" be of such specificity as to put the recipient on "inquiry notice" of the actual fraud, or embezzlement, or looting, or whatever ultimately proves to be the cause of loss. It is sufficient if the red flag puts the investor on notice of some potential infirmity in the investment such that a reasonable investor would recognize the need to conduct some investigation.[27]

If this standard is used to assess the good faith of defrauded Madoff investors, many may have to disgorge withdrawals of principal. This is

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23. *Id.* § 548(d)(2).

24. *In re* Bayou Group, LLC, 396 B.R. 810 (Bankr. S.D.N.Y. 2008).

25. *See, e.g.*, Carrie Coolidge, *Lessons for Madoff Investors from the Bayou Fund Ponzi Scheme*, FORBES.COM, Dec. 12, 2008, http://www.forbes.com/2008/12/12/madoff-redemptions-bayou-biz-wallst-cz_cc_1212madoff.html; Mark Hosenball, *Made Money with Madoff? Don't Count on Keeping It*, NEWSWEEK, Jan. 12, 2009, at 9; Jane J. Kim, *As 'Clawback Suits Loom, Some Investors Seek Cover*, WALL ST. J., Mar. 12, 2009, at C3; Carlyn Kolker et al., *Madoff Victims May Have to Return Profits, Principal*, BLOOMBERG, Dec. 23, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awmAWSxKpXRM; Nicholas Varchaver, *Added Insult to Madoff Investors*, CNNMoney, Dec. 19, 2008, http://money.cnn.com/2008/12/19/news/madoff.legal.fortune/index.htm?postversion=2008121913 (all drawing comparisons to the *Bayou* ruling).

26. *See In re* Bayou Group, 396 B.R. 810, 844-51 (Bankr. S.D.N.Y. 2008).

27. *See id.* at 848.

because, in hindsight, the Ponzi scheme threw up a lot of red flags,[28] some of which may have contributed to withdrawals. It is thought, for example, that there were investors who attributed the success of their investments to front-running, but invested nonetheless because they did not believe that the illegal practice would endanger their money.[29] What investors knew, and how they acted on it, will come out during the discovery phase of clawback litigation.

It is significant that the Ponzi scheme flew under the radar of the Securities and Exchange Commission.[30] Investors invoking the good faith defense will likely try to downplay evidence concerning suspicions they had with respect to the remarkable success of their investments and focus on the SEC's conduct, which the SEC investigated.[31] The argument can certainly be made that an investor should not be deemed to lack good faith based on red flags that the SEC did not spot.

C. Recovery of Avoided Transfers

If a challenged transfer is avoided, it can be recovered from not only the initial transferee but also from those who received a transfer of

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28. *See* GREG N. GREGORIOU & FRANCOIS-SERGE LHABITANT, MADOFF: A RIOT OF RED FLAGS 10-15 (EDHEC Risk and Asset Management Research Centre Jan. 2009), *available at* http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_PP_Madoff_Riot_of_Red_Flags.pdf (discussing red flags 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).

29. *See, e.g.*, *Bernie Madoff: Ponzi Squared*, ECONOMIST.COM, Dec. 15, 2008, http://www.economist.com/businessfinance/displaystory.cfm?story_id=12795543 (subscription required) ("According to reports, some of those who put their faith in Mr. Madoff suspected that he was engaged in wrongdoing, but not the sort that would endanger their money. They thought he might be trading illegally for their benefit on information gleaned by a separate business within his group, which made a market in shares. The firm had been investigated for 'front-running,' using information about client orders to trade for its own account before filling those orders.").

30. *See 60 Minutes: The Man Who Knew* (CBS television broadcast Mar. 1, 2009), *available at* http://www.cbsnews.com/video/watch/?id=4836927n&tag=contentMain;contentBody.

31. *See, e.g.*, Rowena Mason, *SEC Failed to Spot Madoff Fund's "Red Flags"*, DAILY TELEGRAPH (LONDON) ONLINE, Jan. 5, 2009, http://www.telegraph.co.uk/finance/financetopics/bernard-madoff/4127360/SEC-failed-to-spot-Madoff-funds-red-flags.html.

the property from the initial transferee.[32] This concept is important in the Madoff SIPA proceeding because many investors received returns on their investments indirectly through the hedge funds and other intermediaries with which they invested.[33] Both the intermediaries and the investors are potential defendants in clawback litigation.

II. LIMITING THE REACH OF THE CLAW

The trustee mailed out 223 letters demanding the return of $735 million identified by his team as being subject to clawback.[34] The trustee acknowledged the publicity that the letters had drawn in a post on www.madofftrustee.com:

> In an effort to provide some transparency to this process, set forth below are some of the factors that the Trustee will consider when determining whether to commence an avoidance action.
> • Generally speaking, but subject to the remainder of the bullet points, all amounts recoverable as preferences must be repaid to the Trustee. It may be possible to offset amounts received as preferences against the maximum SIPC advance to the Trustee for the satisfaction of each allowed customer claim.
> • As to fraudulent transfers, was the customer a net "winner" or "loser"? In other words, did the customer get back less from BLMIS over the years than it put in. If so, the Trustee is unlikely to commence an action.
> • Would the commencement of an avoidance action create an undue hardship for the customer that received the potentially avoidable transfer(s)? If so, the Trustee is unlikely to commence an action. When considering whether an action would create an undue

32. *See* 11 U.S.C. § 550 (2006).

33. Investors and governmental entities have sued some of these intermediaries. *See, e.g.*, Class Action Complaint, Peshkin v. Tremont Group Holdings, Inc., No. 08-11183 (Bankr. S.D.N.Y. Dec. 23, 2008); Complaint, Cuomo v. Merkin, No. 450879-2009 (N.Y. Sup. Ct. Apr. 6, 2009). Following the collapse of the Ponzi scheme, class actions were also brought against Bernard Madoff. *See, e.g.*, Complaint, Repex Ventures S.A. v. Madoff, No. 09-00289 (S.D.N.Y. Jan. 12, 2009); Class Action Complaint, Kellner v. Madoff, No. 08-5026 (E.D.N.Y. Dec. 12, 2008); *see also* Lindsay Fortado, *Madoff Case Promises Fees for Firms Facing Worst Year in Decades*, BLOOMBERG, Jan. 14, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=aO32KOhrPtRw&refer=us

34. *See* Amir Efrati, *Madoff's Net Losers Safe for Clawbacks*, WALL ST. J., Apr. 24, 2009, at C8; Christopher Scinta et al., *Madoff Trustee Demands Investors Return $735 Million*, BLOOMBERG, Apr. 23, 2009, http://www.bloomberg.com/apps/news?pid=20601110&sid=apnVhVeUN7O8.

> hardship, the Trustee will consider, among other things, the amount sought to be recovered and the particular facts that would give rise to the customer's hardship.
> • Are there particular facts or circumstances—such as a lack of good faith—that make the conduct of the recipient of the potentially avoidable transfer susceptible to being recovered? If so, the Trustee is more likely to commence an avoidance action.
> • Does the recipient of the potentially avoidable transfer have potentially valid defenses to the avoidance claims? If so, the Trustee will evaluate the defenses when determining whether to commence an action.
> • Has the recipient of a demand letter contacted the Trustee's counsel to discuss the facts and circumstances giving rise to the transfer and potential settlements? If so, the Trustee will not commence an action, if at all, while such discussions are taking place. If not, the Trustee may be more likely to commence an action.
> • Are there any other particular facts and circumstances brought to the attention of the Trustee's counsel that the Trustee should consider when determining whether to commence an avoidance action against a recipient of funds?[35]

The guidelines are subject to a disclaimer: "*The Trustee offers the foregoing solely as guidance and nothing herein creates any binding agreement by the Trustee regarding whether he will or will not commence any particular avoidance claim. The foregoing may not be used in any way as a defense to any potential or actual avoidance claim.*"[36] While they do not eliminate the need to seek counsel, the guidelines may offer some comfort to investors who had no reason to suspect they were being defrauded and got much less out of the Ponzi scheme over time than they put in.

The guidelines are also somewhat encouraging for defrauded nonprofit organizations because they may be able to establish an "undue hardship" under the third guideline. Nonprofits have been especially hard hit by the Ponzi scheme. Some that invested heavily with Bernard Madoff have lost substantially all of their assets, including The Elie Wiesel Foundation for Humanity.[37] Nonprofits have also seen a decline

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35. *See* Guidance on the Trustee's Pursuit of Avoidance Recoveries, *available at* http://www.madoff-help.com/wpcontent/uploads/2009/05/picard_guidance_avoidance.pdf.

36. *See id.* (emphasis in original).

37. *See Elie Wiesel Says He Can't Forgive Bernie Madoff*, CNN.COM, Feb. 27, 2009, http://www.cnn.com/2009/CRIME/02/27/wiesel.madoff/index.html; Stephanie Strom, *Elie Wiesel Levels Scorn at Madoff*, N.Y. TIMES, Feb. 26, 2009, at B1.

in donations both because those who donated to them in the past have been defrauded and have less money to donate[38] and because some donors are losing confidence in the ability of nonprofits to safeguard investments.[39] The prospect of a clawback makes for a triple whammy. Nonprofit organizations are not, however, getting a categorical pass; a nonprofit affiliated with people with a close connection to Bernard Madoff was named in one of the first clawback complaints filed by the trustee.[40]

III. THE IMPACT OF SUBMITTING A CLAIM

The trustee has reached out to investors to let them know that their claims must be filed no later than July 2, 2009 in order to be considered.[41] Timely filed customer claims will yield distributions from SIPC[42] and other funds disbursed by the trustee. SIPC funding is currently capped at $500,000 per claim.[43]

The invitation to file claims has been called a "Trojan Horse"[44] because, as explained below, by submitting claims for recovery of net

38. *See* Associated Press, *Charities Hurt in Madoff Case Get Charity: Foundations Trying to Help Nonprofits That Lost Millions in Alleged Scheme*, Jan. 6, 2009, *available at* http://www.msnbc.msn.com/id/28528375/.

39. *See* Elizabeth Bernstein, *After Madoff, Donors Grow Wary of Giving: But You Can Spot Red Flags Before You Write Out a Check; a Guideline for Vetting Charities*, WALL ST. J., Dec. 23, 2008, at D1.

40. *See* Complaint, *In re* Madoff, No. 08-01789 (Bankr. S.D.N.Y. May 12, 2009), *available at* http://www.madofftrustee.com/CourtFilings-Download.aspx?Docket=277 (naming as a defendant the Picower Institute for Medical Research).

41. According to the Securities and Exchange Commission and Securities Investor Protection Corporation, on January 2, 2009, the trustee mailed claim forms to more than 8,000 customers and creditors of Bernard L. Madoff Investment Securities LLC. SEC, Information for Madoff Customers, http://sec.gov/divisions/enforce/claims/madoffsipc.htm (last visited Oct. 2, 2009); Press Release, Securities Investor Protection Corp., Madoff Liquidation Trustee Mails More Than 8,000 Customer Claims Forms (Jan. 5, 2009), *available at* http://www.sipc.org/media/release05Jan09.cfm.

42. The Securities Investor Protection Corporation (SIPC) was established pursuant to 15 U.S.C. § 78ccc (2006). See http://www.sipc.org for information about how SIPC operates.

43. *See* Trustee Announces Hardship Program, http://www.madofftrustee.com/HardshipProgram.aspx. [hereinafter Hardship Program].

44. *See, e.g.*, Robert Wayne Pierce, *Madoff—The Trojan Horse and the Lion*, http://www.secatty.com/Madoff.shtml (last visited Oct. 1, 2009); Pamela A. MacLean, *A New Legal Industry: Madoff*, NAT'L L.J., Jan. 26, 2009, at 1.

equity,[45] investors subject themselves to the jurisdiction of the Bankruptcy Court for clawbacks. Claims submitted by those with potential clawback exposure are not eligible to receive a distribution of SIPC funds until the clawback issues are resolved.[46]

The filing of a bankruptcy claim subjects the claimant to the Bankruptcy Court's jurisdiction. "The filing of a proof of claim by a creditor is not merely a means of providing information to the bankruptcy court, but is a submission to the bankruptcy court's jurisdiction to establish that creditor's right to participate in the distribution of the bankruptcy estate. By filing a claim against the estate, a creditor triggers the process of allowance and disallowance of claims and an adversary proceeding seeking recovery against the creditor becomes part of that claims allowance process."[47] Likewise, submitting a claim in a SIPA proceeding results in the claimant being deemed to have submitted to the jurisdiction of the Bankruptcy Court and forfeiting jury trial rights with

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45. *See* 15 U.S.C. § 78lll(11) (2006):

> The term "net equity" means the dollar amount of the account or accounts of a customer, to be determined by—
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> (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer (other than customer name securities reclaimed by such customer); minus
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> (B) any indebtedness of such customer to the debtor on the filing date; plus
>
> (C) any payment by such customer of such indebtedness to the debtor which is made with the approval of the trustee and within such period as the trustee may determine (but in no event more than sixty days after the publication of notice under section 78fff-(2)(a) of this title).
>
> In determining net equity under this paragraph, accounts held by a customer in separate capacities shall be deemed to be accounts of separate customers.

Id. Litigation has been commenced to challenge the trustee's method for calculating net equity. *See* Noeleen G. Walder, *Madoff Victims Blast Trustee's Valuations of Their Investments*, N.Y. L.J., June 11, 2009, at 1. *See also* Motion by Trustee for an Order to Schedule Hearing on "Net Equity" Issue, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Aug. 27, 2009).

46. *See, e.g.*, Germain v. Conn. Nat'l Bank, 988 F.2d 1323, 1327 (2d Cir. 1993) ("Under the Bankruptcy Code a court must disallow 'any claim of any entity from which property is recoverable' because of a preferential transfer or fraudulent conveyance" (citing 11 U.S.C. § 502(d) (1978)).). Perhaps there will be accelerated distributions to individual investors who qualify for expedited payment under the trustee's "Hardship Program." *See* Hardship Program, *supra* note 43.

47. *In re* Cruisephone, Inc., 278 B.R. 325, 330 (Bankr. E.D.N.Y. 2002) (citing Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989); Katchen v. Landy, 382 U.S. 323 (1966)).

respect to fraudulent transfer and preference actions.[48]

Investors seeking to preserve their jury trial rights may, therefore, decide not to submit claims. Foreign investors may be especially leery of submitting claims because courts consider whether a foreign defendant has submitted a claim in determining whether they have personal jurisdiction over the defendant.[49] Funds that channeled their clients' money into the Ponzi scheme, in particular, may forego the opportunity to submit claims because with the benefit of the limited SIPC funding that is available comes the risk of exposure to clawback litigation in the Bankruptcy Court.

Other investors may decide not to file to maximize returns under the new tax rules governing theft losses.[50] The new tax rules and the trustee's clawback guidelines both focus on how an investor fared overall. The trustee's guidelines provide: "As to fraudulent transfers, was the customer a net 'winner' or 'loser'? In other words, did the customer get back less from BLMIS over the years than it put in. If so, the Trustee is unlikely to commence an action."[51] The tax rules, in turn, provide that "qualified investments" for purposes of calculating the amount of a theft loss are based on the investor's net position.[52] So, under the guidelines and the new tax rules, respectively, some of the

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48. *See, e.g.*, *In re* Cont'l Capital Sec., No. 3:06-CV-02394-JGC, 2007 WL 5964307, at **1-2 (N.D. Ohio Sept. 19, 2007); *In re* Blinder Robinson & Co., 135 B.R. 892, 896 (Bankr. D. Colo. 1991).

49. *See, e.g.*, Lykes Bros. S.S. Co. v. Hanseatic Marine Serv. (*In re* Lykes Bros. S.S. Co.), 207 B.R. 282, 285-86 (Bankr. M.D. Fla. 1997).

50. *See* I.R.S. REV. PROC. 2009-20 § 2.02 (2009) (regarding 26 C.F.R. § 601.105), *available at* http://www.irs.gov/pub/irs-drop/rp-09-20.pdf.

51. *See* Guidance on the Trustee's Pursuit of Avoidance Recoveries, *supra* note 35.

52. *See* I.R.S. REV. PROC. 2009-20 § 4.06(1)(a)-(b).

> (1) Qualified investment means the excess, if any, of—
>
> (a) The sum of—
>
> (i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years; plus
>
> (ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over
>
> (b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).

Id.

defrauded "net losers" may not be subject to clawback and may recover a portion of their losses by way of tax relief. Conversely, investors who are "net winners" may not file claims because they got more cash out of the Ponzi scheme than they put in or withdrew their investments prior to its collapse.[53] Other investors may not file claims because of privacy concerns or may simply miss the deadline.[54]

Some investors may file fruitless claims because they do not qualify as customers. "Customer" is a term of art in the context of SIPA liquidations.[55] As one federal appellate court explained: "[Th]e definition embodies a common-sense concept: An investor is entitled to compensation from the SIPC only if he has entrusted cash or securities to a broker-dealer who becomes insolvent; if an investor has not so entrusted cash or securities, he is not a customer and therefore not entitled to recover from the SIPC trust fund."[56] In other words, an indirect investor whose money was channeled to Bernard L. Madoff Investment Securities, LLC by a fund, may be deemed ineligble to participate in SIPC distributions.

Investors who do not file claims can consent to a bench trial before the Bankruptcy Court[57] or file a motion seeking removal of their actions

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53. *See* Motion for an Order Modifying the December 23, 2008 Order Establishing Deadlines for the Filing of Customer Claims, SIPC v. Bernard L. Madoff Inv. Sec., LLC, Adv. Pro. No. 08-1789-BRL (Bankr. S.D.N.Y. Feb. 10, 2009), *available at* http://www.madofftrustee.com/CourtFilings-Download.aspx?Docket=261 (seeking relief from deadline for filing claims for entities that did not have existing claims, but could potentially file claims under Bankruptcy Code section 502(h) for any sums disgorged through avoidance actions after the deadline); *see also* Order Denying Motion to Modify Order Establishing Deadlines for the Filing of Customer Claims, SIPC v. Bernard L. Madoff Inv. Secs., LLC, Adv. Pro. No. 08-1789-BRL (Bankr. S.D.N.Y. Feb. 25, 2009), *available at* http://www.madofftrustee.com/CourtFilings-Download.aspx?Docket=21.

54. SIPA sets time limitations on the filing of claims. *See* 15 U.S.C. § 78fff-2(a)(3) (2006).

55. See Annotation, Validity, Construction, and Application of Securities Investor Protection Act of 1970 (15 U.S.C.S. §§ 78aaa et seq.) 23 A.L.R. FED. 157 § 18 (1975 & Supp. 2008).

56. *See In re* Brentwood Secs., Inc., 925 F.2d 325, 327 (9th Cir. 1991); *see also* 15 U.S.C. § 78lll(2) (2006) (defining "customer").

57. *See* 28 U.S.C. § 157(e) (2006).

> If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.

Id. Fed. R. Bankr. P. 9015(b) (1998) provides:

to District Court.[58] In a press release dated May 14, 2009, the trustee and the SIPC president announced that, as of the day before, 8,848 claims had been filed.[59] According to the trustee's First Interim Report, as of July 9, 2009, the trustee had received over 15,400 customer claims.[60] Assuming that not all of the investors sued by the trustee submit to the jurisdiction of the Bankruptcy Court, clawback litigation will be decentralized.[61]

IV. STREAMLINING LITIGATION

There is already a flurry of litigation outside of the Bankruptcy Court. Class actions against Bernard Madoff and intermediaries have been filed in the United States District Court for the Southern District of New York.[62] There is also Madoff-related litigation outside of the Southern District.[63]

International litigation may be on the horizon as well. Shortly after the commencement of the SIPA liquidation, England's High Court of Justice, Chancery Division, Companies Court ordered that Madoff Securities International Ltd. be placed into a provisional liquidation and appointed joint provisional liquidators.[64] The trustee has sought to em-

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> If the right to a jury trial applies, a timely demand has been filed pursuant to Rule 38(b) Fed. R. Civ. P., and the bankruptcy judge has been specially designated to conduct the jury trial, the parties may consent to have a jury trial conducted by a bankruptcy judge under 28 U.S.C. § 157(e) by jointly or separately filing a statement of consent within any applicable time limits specified by local rule.

Id.

58. *See* 28 U.S.C. § 157(d) (2006); *see also* S.D.N.Y. LOCAL BANKR. R. 5011-1 (2008).

59. *See* Press Release, SIPC, SIPC: $61 Million in Commitments Made to Madoff Claimants, With $100 Million Level Expected to be Reached by Memorial Day (May 14, 2009), *available at* http://www.madofftrustee.com/News-Download.aspx?PressRelease=15.

60. *See* Trustee's First Interim Report for the Period December 11, 2008 Through June 30, 2009 at 2 n.2, SIPC v. Bernard L. Madoff Inv. Sec., LLC, Adv. Pro. No. 08-1789-BRL (Bankr. S.D.N.Y. July 9, 2009), *available at* http://www.madofftrustee.com/CourtFilings-Download.aspx?Docket=163.

61. *See* Kim, *supra* note 25 (discussing reluctance to file claims and investors' asset protection strategies).

62. *See supra* note 33.

63. *Id.*

64. *See* Trustee's Motion to Retain Special Counsel *Nunc Pro Tunc* as of January 15, 2009 at ¶ 9, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. 2009).

ploy Lovells LLP[65] and other special counsel[66] to assist with issues arising overseas and is coordinating with the joint provisional liquidators.[67] In the lead case on the international reach of preference actions brought under the Bankruptcy Code, the United States Court of Appeals for the Second Circuit concluded that principles of comity counseled against applying the preference provisions to avoidance claims asserted in the Chapter 11 case of a debtor, which was subject to joint, cooperative proceedings in England.[68] Perhaps the liquidators in London can claw back transfers the trustee cannot otherwise reach.[69]

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65. *See id.* at ¶ 11 (seeking authority to employ Lovells LLP "with regard to the foreign proceeding of MSIL, and any matters related to other foreign proceedings").

66. *See, e.g.*, Trustee's Motion for Authority to Retain Special Counsel *Nunc Pro Tunc* as of February 8, 2009 at ¶ 11, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. 2009) (seeking authority to retain the law firm of Eugene F. Collins as special counsel "with regard to the [proceedings before the High Court in Dublin, Ireland], and any matters related to other proceedings in Ireland"); Trustee's Motion for Authority to Retain Special Counsel *Nunc Pro Tunc* as of March 13, 2009 at ¶ 10, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. 2009) (seeking authority to retain the law firm of Attias & Levy as special counsel "with regard to its recovery of customer property in Gibraltar, and any related matters"); Trustee's Motion for an Order Approving the Retention of Schiltz & Schiltz as Special Counsel *Nunc Pro Tunc* as of March 30, 2009 at ¶ 10, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. 2009) (seeking authority to retain the law firm of Schiltz & Schiltz as special counsel "with regard to its recovery of customer property in Luxembourg, and any related matters").

67. Order Pursuant to Sections 1526, 1527 and 105(a) of the Bankruptcy Code Approving Protocols by and Between the Trustee and the Joint Provisional Liquidators of Madoff Securities International Limited, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. 2009).

68. *See In re* Maxwell Comm. Corp., 93 F.3d 1036 (2d Cir. 1996).

69. In a judgment issued on February 12, 2009, the European Court of Justice held "that the courts of the Member states within the territory of which insolvency proceedings have been opened have jurisdiction to decide an action to set a transaction aside by virtue of insolvency that is brought against a person whose registered office is in another Member State." *See* Case C-339/07, Christopher Seagon, in his capacity as liquidator in respect of the assets of Frick Teppichboden Supermärkte GmbH v. Deko Marty Belgium NV, 2009 E.C.J. Eur.-Lex LEXIS 120 (Feb. 12, 2009). The trustee for Bernard Madoff's Chapter 7 estate can also bring avoidance actions. An involuntary petition for relief was filed against Bernard Madoff in April of 2009 and, thereafter, a trustee was appointed. While the Chapter 7 estate was consolidated into the estate of Bernard L. Madoff Investment Securities, LLC, the Chapter 7 trustee retained the ability to bring avoidance actions under Chapter 5 of the Bankruptcy Code. *See* Consent Order Substantively Consolidating the Estate of Bernard L. Madoff into the SIPA Proceeding of Bernard L. Madoff Investment Securities LLC and Expressly

The foregoing demonstrates that there is great potential for inconsistent results, delayed adjudication, and skyrocketing costs. As a result, the need for streamlining and coordinating the Madoff-related civil litigation is acute. Procedures utilized in some complex cases follow by way of suggestion.

A. Collins & Aikman: Setting Deadlines & Establishing Mediation Procedures

On May 17, 2005, Collins & Aikman Corporation and affiliates sought Chapter 11 protection.[70] The debtors and their domestic and foreign non-debtor affiliates were leading global suppliers of automotive parts, with total sales of approximately $4 Billion in 2004,[71] and there were approximately 75,000 creditors in the Chapter 11 cases.[72]

The debtors identified thousands of potentially voidable preferential and fraudulent transfers, which were made by the debtors during the 90 days preceding the bankruptcy submitting.[73] Special Counsel retained on a contingency fee basis filed over 1,100 complaints, each of which sought recovery from recipients of transfers during the preference period totaling more than $25,000.[74]

The Bankruptcy Court entered Orders to facilitate the resolution of the high volume litigation. Prior to the commencement of the cases, the Court put procedures into place that, among other things, set omnibus hearing dates and deadlines for (1) serving complaints and motions to amend complaints; (2) submitting answers to complaints and responses

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Preserving all Rights, Claims and Powers of Both Estates at ¶¶ E, F, G, 3 & 4, SIPC v. Bernard L. Madoff Inv. Sec. LLC, Adv. Proc. No. 08-01789 (Bankr. S.D.N.Y. June 9, 2009).

70. *See* First Day Motion for Entry of an Order Designating Cases as "Large Bankruptcy Cases," *In re* Collins & Aikman Corp., Chapter 11 Case No. 05-55927 (Bankr. E.D. Mich. May 17, 2005), *available at* http://www.kccllc.net/documents/0555927/05559270505170000000000055.pdf.

71. *See id.* at ¶¶ 5-6.

72. *See id.* at ¶ 10.

73. *See In re* Collins & Aikman, Third Semi-Annual Report of the Collins & Aikman Litigation Trust Administrator in Accordance with Section 4.4(d) of the C & A Litigation Trust Agreement, Aug. 13, 2009, at 2, *available at* http://www.kccllc.net/documents/0555927/05559270908130000000000001.pdf [hereinafter Collins & Aikman Report].

74. *See id.* at 2-3.

to motions to amend complaints; and (3) discovery.[75]

The Bankruptcy Court subsequently "conclude[d] that it [was] in the best interests of all of the parties in these adversary proceedings to appoint mediators to attempt to facilitate resolutions of these adversary proceedings." The Court also "conclude[d] that the mediation procedures established in [the Order Regarding Mediation] will promote the just, speedy and inexpensive resolution of these adversary proceedings."[76] The Order Regarding Mediation, among other things, (1) stayed all actions in which a responsive pleading had been filed; (2) appointed mediators; (3) required that mediations take place three days each week; (4) established rules governing conduct of mediations; (5) fixed costs; and (6) provided conflict and opt-out provisions.[77]

The results of the procedures put into place by the Bankruptcy Court are remarkable. As of June 30, 2009, fewer than thirty cases remained open, and nearly $50 Million had been recovered through resolution of the balance of the preference cases.[78]

B. Enron: The MegaComplaint & Coordinating Multidistrict Litigation

After the infamous collapse of Enron and the ensuing bankruptcy submittings,[79] the Enron debtors filed a complaint in Enron's bankruptcy proceedings alleging multiple causes of action, including clawbacks, against Enron's former lender banks (the "MegaComplaint").[80] In the

75. *See, e.g.*, Order Establishing Procedures and Deadlines for Adversary Proceedings "Track 1," No. 05-55927 (SWR), *In re* Collins & Aikman Corp. (E.D. Mich. May 1, 2007). Parallel Orders were entered for cases brought in Tracks II and III, in which the debtors sought recovery of greater amounts. *See, e.g.*, Procedures and Deadlines for Adversary Proceedings "Track 2," No. 05-55927 (SWR), *In re* Collins & Aikman (E.D. Mich. May 1, 2007).

76. *In re* Collins & Aikman Corp., 376 B.R. 815, 816 (Bankr. E.D. Mich. 2007).

77. *See id.* at 816-17.

78. *See* Collins & Aikman Report, *supra* note 73, at 1, 5-6 (discussing outstanding results achieved by Togut, Segal & Segal LLP).

79. *See generally In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002), First Interim Report of Neal Batson, Court-Appointed Examiner, *available at* http://www.enron.com/media/1st_Examiners_Report.pdf (describing Enron's collapse and some of the transactions preceding it).

80. *See* Reorganized Debtors' Fourth Amended Complaint for the Avoidance and Return of Preferential Payments and Fraudulent Transfers, Equitable Subordination, and Damages, Together with Objections and Counterclaims to Creditor Defendants' Claims, Enron Corp. v. Citigroup Inc., No. 01-16034, Adv. No. 03-09266 (S.D.N.Y. Jan. 10,

MegaComplaint, Enron sought a recovery from "the banks and investment banks that bear substantial responsibility for the stunning downfall of what was once the seventh largest corporation in the United States" based on a "multi-year scheme to manipulate Enron's financial statements and misstate its financial condition."[81] The MegaComplaint consolidated, in a single proceeding, thousands of actions collectively seeking recovery of Billions of Dollars, based on bankruptcy causes of action and related claims under state and common law.[82]

Outside of the Bankruptcy Court, shareholders filed more than seventy class actions seeking damages for their losses, which were transferred to the Southern District of Texas by the Judicial Panel on Multidistrict Litigation.[83] This was done pursuant to 28 U.S.C. § 1407, which provides: "When civil actions involving one or more common questions of fact are pending in different districts, such actions may be transferred to any district for coordinated or consolidated pretrial proceedings."[84] Actions can be transferred by either the judicial panel on multidistrict litigation, by its own initiative, or by motion to the panel filed by a party to an action seeking to coordinate or consolidate pretrial proceedings.[85]

By coordinating with respect to pretrial matters, through measures such as jointly entering a Deposition Protocol Order,[86] the Bankruptcy Court and the District Court streamlined discovery and facilitated resolution of highly complex issues. The coordinated litigation resulted in a $7.2 billion shareholder settlement.[87] According to Enron Creditors Recovery Corp., payouts to creditors are in excess of $21.5 billion.[88]

2005).

81. *See id.* at ¶ 1.

82. *See id.* Enron also filed complaints asserting multiple causes of action against a host of defendants as part of the Commercial Paper Litigation and Equity Transactions Litigation. For descriptions of these lawsuits, see http://www.enron.com/index.php?option=com_content&task=section&id=3&Itemid=4 (last visited Oct. 1, 2009).

83. *See* Newby v. Enron Corp., 302 F.3d 295, 299 (5th Cir. 2002).

84. 28 U.S.C. § 1407(a) (2006).

85. *See id.* § 1407(c).

86. *See In re* Enron Corp. Sec. Litig., Deposition Protocol Order (Bankr. S.D. Tex. Mar. 11, 2004).

87. *See* Kristen Hays, *Enron Payout Plan Approved: Shareholders May See Some Money Before the End of the Year*, HOUS. CHRON., Sept. 9, 2008, at Bus. 1.

88. *See* Enron Creditors Recovery Corp., Payments to Date (Apr. 1, 2009), http://www.enron.com/index.php?option=com_content&task=view&id=15&Itemid=25 (last visited Oct. 1, 2009).

CONCLUSION

The clawback actions and other litigation arising out of the collapse of the Ponzi scheme orchestrated by Bernard Madoff will try to right many wrongs. Thought should be to how to achieve resolution without compounding the damage already suffered. The procedures in complex Chapter 11 proceedings described above maximized returns and reduced both costs and delay. Proposals for the resolution of Madoff-related litigation should come sooner rather than later and are hereby invited.