

“Clawbacks” in the Aftermath of Madoff and Other Investment Frauds

By Bennett W. Lasko

Thousands of investors that entrusted money to Bernard Madoff or one of the feeder funds that directed investments to him woke up in mid-December thinking that the news couldn't get any worse. Then someone told them about “clawbacks.”

Nearly three months later, we find that many of our friends and clients have received conflicting or confusing information about what clawbacks are, who can assert them and what is likely to be clawed back. This alert will try to set the record straight on the basic rules, which can be summarized fairly simply even though difficult issues can arise when they are applied to a complex situation like the Madoff fraud.

“Clawback” is a nickname for several interrelated types of claims that can be asserted by a bankruptcy trustee to recover money paid out to investors in a Ponzi scheme before the scheme was revealed. Broadly speaking, the function of a clawback is to recover payments that were made out of the corrupt fund before the scheme was discovered and return those monies to the bankruptcy estate so that they can be distributed to creditors – *i.e.*, the victims of the fraudulent scheme – in accordance with the priorities established by the Bankruptcy Code. Clawback claims come in two types: preferences actions and fraudulent conveyance actions.

Preferences

With a few exceptions that are unlikely to be relevant in a typical investment fraud, the trustee is entitled to recover the full amount of all withdrawals by any investor – whether of principal or earnings – within 90 days prior to the date of the bankruptcy petition. Such payments are called “preferences” because they are presumed by the law to have “preferred” the interests of the withdrawing creditor over the interests of other creditors at a time when bankruptcy already may have been imminent.

In certain circumstances where the payment was to an insider or for the benefit of an insider, the trustee can recover preference claims over a one-year look-back period, rather than only 90 days. This longer period generally will not apply to redemptions or withdrawals by investors that were at arm's length from a corrupt investment fund and the people running it.

Investors who are required to return a withdrawal of principal under the preference rules will have an unsecured claim against the bankruptcy estate for that amount.

Fraudulent Conveyances – Profits versus Principal

The rules that apply outside the preference period are governed by the law of fraudulent conveyances and are best understood in light of the key feature of a Ponzi scheme – i.e., that the supposed profits paid out to some investors are not really profits at all, but are taken by the schemers from the investment principal of other investors. This feature sets up an important distinction in how the law treats two kinds of transfers that investors can receive from a Ponzi scheme: withdrawals of fictitious profits versus redemptions of principal.

The basic rule is that withdrawals of fictitious profits have to be returned to the bankruptcy estate, whereas redemptions of principal do not, unless the investor knew or should have known of “red flags” at the time of the transaction. This rule applies under both the fraudulent transfers provision of the Bankruptcy Code and parallel provisions of state law.

Transfers “For Value”

The key underlying legal concept is whether the transfer from the corrupt investment fund was “for value.” A redemption of principal is considered to be a transfer for value. The courts have held that when an investor invests in a fraudulent fund, the investor accrues a claim against the fund and its operators for rescission of the investment. If that investor later redeems all or part of his principal, the investor’s claim for rescission is reduced dollar-for-dollar by the amount of the redemption. This reduction of the claim for rescission is considered to be an exchange of equivalent value for the cash received on redemption.

Consider a simple example: Investor A deposited \$1 million in a discretionary trading account with Madoff Securities, which Investor A did not know or have any reason to know was a Ponzi scheme. At the moment of making the deposit, Investor A accrued a claim against Madoff Securities for return of his \$1 million. A year or two later, Investor A showed an account balance of \$1.4 million and took \$400,000 out of the account. That redemption reduces Investor A’s claim for return of the original \$1 million to a claim for \$600,000. The reduction, in turn, is considered by the law to be an exchange of equivalent value for the \$400,000 redemption. (As the example illustrates, investments and redemptions are tracked on a simple first in, first out cash basis.)

Good Faith

Under both the Bankruptcy Code and state law, an investor who received a redemption of principal in exchange for reasonably equivalent value may retain the redemption as long as the investor acted with “good faith.”

Courts apply an objective, not subjective, test of good faith in this context that has little to do with familiar notions of good intentions or “pure heart.”

The test is not what the redeeming investor actually knew or believed, but whether a reasonable person in the position of the redeeming investor would have known *or should have discovered* that the investment scheme was fraudulent.

Several courts have formulated the test to say that a transferee does not take in good faith “if the circumstances would have placed a reasonable person on inquiry of a debtor’s fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose.” In summary, the standard can be described as whether the investor knew or should have known of “red flags” indicating a fraud may have been afoot or that would have led a prudent investor to undertake a further investigation.

Whether or not a specific set of facts can defeat a good faith defense is decided on a case-by-case basis. In a lengthy and complex set of litigations arising from the 2005 collapse of the Bayou Funds, for example, the court identified as red flags such facts as an investor’s knowledge of an FBI investigation, a lawsuit filed by a former employee alleging that the fund managers violated SEC policies and engaged in other financial improprieties, the discovery that the funds’ offshore administrator did not independently confirm assets or verify net asset values (NAVs), the fact that the CFO of the fund manager was the registered agent for the funds’ supposedly independent accounting firm, and refusals by the fund manager to answer questions about the former employees’ lawsuit, provide access to documentation to support the NAVs, or allow a meeting with the funds’ auditor.

Sometimes, an investor’s knowledge of or access to a combination of several facts might defeat a good faith defense even if none of the facts individually would have been enough to do so.

False Profits

Redemptions from a Ponzi scheme in excess of an investors’ principal – *i.e.*, withdrawals of false profits – are not “for value.” Once the investor has recovered her original investment, the underlying claim for rescission goes to zero, so there is no offsetting exchange by the investor for the withdrawal of false profits. Such withdrawals, of course, do not represent any true profit at all, but by definition in a Ponzi scheme are paid from principal invested by other investors.

Under the law, transfers that are not for value are presumed to be fraudulent regardless of any knowledge or intent on the part of the redeeming investor and are not subject to a good faith defense. Thus, investors who received more money from Madoff investments than the amount of their original principal reasonably can expect to be subject to claw-back claims for return of the difference.

Indirect Investors

Many investors – perhaps most – did not directly establish accounts with Madoff Securities. Instead, they invested indirectly through feeder funds or other intermediaries. Some of those feeder funds were invested entirely with Madoff and have no meaningful assets remaining (other than perhaps the hope of recovering a portion of their losses). Many investors were exposed to Madoff through multiple intermediaries, such as by investing in a fund of funds that, in turn, allocated money to a feeder fund.

Section 550 of the Bankruptcy Code authorizes a trustee to recover fraudulent convey-

ances from both direct and indirect recipients (in the language of the code, “any immediate or mediate transferee of [an] initial transferee”). Thus, if a feeder fund that withdrew false profits from Madoff Securities lacks the assets to repay them, there is some risk that the Madoff trustee will assert claims to recover those false profits from investors in the feeder fund that benefited from those false profits. The trustee likely can use the court’s subpoena power to obtain fund records to determine who those investors are.

Several complex problems can arise with respect to indirect investors, including when, whether and how redemptions or withdrawals from Madoff can be traced through multiple entities to ultimate recipients, and how the burdens of a clawback action should be allocated between and among current and former investors in a fund that is forced to repay past withdrawals.

Limitations Periods

A bankruptcy trustee is allowed two years from the filing of the bankruptcy petition to assert preference or avoidance actions. As noted above, preference actions will apply to transfers that occurred up to 90 days prior to the bankruptcy filing. Fraudulent conveyance actions under the Bankruptcy Code apply to transfers occurring up to two years prior to the bankruptcy petition. Thus, the Madoff trustee will be able to assert claims to recover withdrawals of false profits that occurred on or after December 16, 2006. State law claims for fraudulent transfer or fraudulent conveyance are subject to different limitations periods in different states, ranging from two to six years.

The Madoff trustee may encounter substantial practical limitations on his ability to reach back so far in time, such as difficulties of reconstructing records or locating transferees, or the sheer administrative burdens of pursuing many thousands of claims. For these and other reasons, the trustee ultimately may decide only to pursue clawbacks over a shorter period than the maximum allowed by the law.

Recent Madoff Trustee Comments

Consistent with the foregoing summary, attorneys for the Madoff trustee are reported to have stated at a recent investor meeting that they would be seeking clawbacks from investors who pulled out more money than they put into a Madoff account, and from large investors that knew or should have known of the fraud when redeeming principal.

Conclusion

We expect that investors who are in a net loss position on their Madoff investments (on a cash in, cash out basis) will not be subject to clawback claims unless there are special facts about their situation indicating that they knew or should have known something was amiss. Investors in a net gain position may be subject to a claim under federal or state law for return of any profits they withdrew from Madoff investments in the two to six years preceding December 16, 2008.

For more information about the matters discussed in this alert, please contact any member of our Hedge Funds Task Force or your regular Drinker Biddle contact.

Hedge Funds Task Force

Bradley J. Andreozzi
(312) 569-1173
Bradley.Andreozzi@dbr.com

Warren von Credo Baker
(312) 569-1350
Warren.Baker@dbr.com

Jeffrey Blumberg
(312) 569-1106
Jeffrey.Blumberg@dbr.com

Stephen T. Burdumy
(215) 988-2880
Stephen.Burdumy@dbr.com

Daniel J. Delaney
(312) 569-1175
Daniel.Delaney@dbr.com

Joshua B. Deringer
(215) 988-2959
Joshua.Deringer@dbr.com

Matthew Farley
(212) 248-3150
Matthew.Farley@dbr.com

Kristin K. Going
(202) 230-5177
Kristin.Going@dbr.com

Barry Gross
(215) 988-2872
Barry.Gross@dbr.com

Bennett W. Lasko
(312) 569-1174
Bennett.W.Lasko@dbr.com

Charles S. Leeper
(202) 842-8877
Charles.Leeper@dbr.com

Michael P. Malloy
(215) 988-2978
Michael.Malloy@dbr.com

David M. Matteson
(312) 569-1145
David.Matteson@dbr.com

Brian F. McDonough
(212) 248-3160
Brian.McDonough@dbr.com

Michael W. McTigue, Jr.
(215) 988-2742
Michael.McTigue@dbr.com

Gregory P. Miller
(215) 988-1103
Gregory.Miller@dbr.com

Michael R. Miner
(202) 354-1379
Michael.Miner@dbr.com

Debra M. Patalkis
(202) 842-8833
Debra.Patalkis@dbr.com

Edward M. Posner
(215) 988-2716
Edward.Posner@dbr.com

Mary Jo Reilly
(215) 988-1137
Maryjo.Reilly@dbr.com

Stephen G. Stroup
(215) 988-2547
Stephen.Stroup@dbr.com

Audrey C. Talley
(215) 988-2719
Audrey.Talley@dbr.com

Other Publications



www.drinkerbiddle.com/publications

Sign Up



www.drinkerbiddle.com/publications/signup

Drinker Biddle

Hedge Funds Task Force

CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN