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What's a Clawback? – A Basic Explanation of the Madoff "Clawbacks" and Related Issues

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Provided you have not been hiding under a rock, you have at least some familiarity with the huge Ponzi scheme orchestrated by Bernard Madoff through his investment firm Bernard L. Madoff Investment Securities ("BLMIS"). Stories of Ponzi schemes have become so familiar that most people now have an understanding of what is meant when an enterprise is called a "Ponzi scheme." The Madoff debacle has now introduced many people to a new term: the "clawback." In light of the potential impact these claims may have on many accounting firm clients, this article provides a basic explanation of what clawback claims are, how they work, and some of the fundamental issues associated with these claims.

What is a Clawback Claim?

At the same time that Bernie Madoff was being indicted for criminal securities fraud, the Securities and Exchange Commission ("SEC") and the Securities Investor Protection Corp. (SIPC) were taking action to place BLMIS in liquidation pursuant to the Securities Investor Protection Act (SIPA). The BLMIS liquidation is fundamentally the same as a bankruptcy proceeding—the proceeding is taking place in U.S. Bankruptcy Court, a Trustee has been appointed to administer the liquidation, and the Bankruptcy Code, among other bodies of law, is applicable. As a result, the claims and controversies at issue in the BLMIS liquidation are similar to those seen in many bankruptcy proceedings.

"Clawback" is the term being used for the claims that the Trustee can assert against investors and intermediaries to potentially recover money BLMIS paid out prior to the scheme being exposed. The purpose of these claims is to pull these payments back into the BLMIS estate—or claw them back—so that they later can be distributed with the rest of the estate to the BLMIS creditors in accordance with the priorities established by the Bankruptcy Code. There are two fundamental types of clawback claims: preference actions and fraudulent conveyance actions.

Preference Actions

The law presumes that payments made very shortly before an entity becomes insolvent afforded the recipient preferential treatment to the detriment of the entity's other creditors. A preference action seeks to set aside the preferential payment and put the money back into the estate so it can be fairly distributed to all creditors alike. That the recipient is innocent of any wrongdoing is irrelevant to preference considerations. The purpose is not to punish those who received such payments, but rather to promote fairness to all investors and creditors by making those that received money just before the collapse return the money and be treated like all other investors.

In preference actions, the Trustee can recover the entire amount of any payments received from BLMIS within 90 days prior to the filing date. For any payments made to insiders or to benefit insiders, the Trustee can recover any amounts paid by the debtor within one year of the filing date. The filing date for the BLMIS liquidation was December 11, 2008, so the look-back period for preference claims would extend back to September 10, 2008 for most claims, but will go back to December 11, 2007 for any payments to insiders or for their benefit. The Trustee has two years from the filing date, or until December 11, 2010, to commence any preference action he decides to pursue. Madoff investors required to return preferential payments may have an unsecured claim against the estate.

Fraudulent Conveyances

There are essentially two types of fraudulent conveyance claims available to the Trustee. The first, and more predominant claim, is constructive fraud based on receipt of money or assets from the debtor without having provided anything of reasonably equivalent value in return for the transfer. This type of claim does not require intent to defraud or a guilty mind; it just requires receipt of the debtor's assets without having provided the debtor with anything of appropriate value in return. The second type of fraudulent conveyance claim requires some proof of a guilty mind, such as taking money or assets when it is known or should have been known that it was inappropriate to receive the assets.

In the context of a Ponzi scheme and its investors, the issue of reasonably equivalent value focuses on whether the investor is withdrawing more or less than originally invested. The original investment constitutes value given to the debtor, so withdrawals amounting to no more than the original investment generally are not subject to fraudulent conveyance claims so long as the investor had no reason to know about the fraud. However, if more than the original investment is withdrawn, the investor's withdrawal of the false profits generated by the Ponzi scheme really amounts to a withdrawal of another investor's principal investment. Thus, the general rule is that fictitious profits withdrawn from the Ponzi scheme have to be returned to the debtor, whereas redemptions of principal do not have to be returned *unless* the investor knew or should have known at the time of the withdrawal that something was amiss.

While the foregoing would seem to indicate that an investor who only redeemed principal should have little to fear, the test for whether an investor redeemed the principal in good faith can be difficult to assess sometimes. The legal test for whether the redemption was made in good faith requires the court to assess whether the circumstances would have placed a reasonable person on notice of the debtor's fraudulent practices or caused a prudent investor to undertake further investigation that would have revealed the fraud. Prior cases have focused on whether there were "red flags" pointing to the fraudulent nature of the Ponzi scheme, and many of the current lawsuits involving Madoff losses assert that there were many "red flags" indicating BLMIS was a Ponzi scheme.

In the case *In re Bayou Group, LLC*, the court extensively reviewed the good faith defense in the context of a trustee seeking recovery of both principal and false profits from investors in another recent Ponzi scheme. The *Bayou* court identified several factors that should have constituted "red flags" to the *Bayou* investors that are also present in the Madoff situation. In fact, the pleadings being filed by the BLMIS Trustees, as well as those being filed on behalf of certain investors against the feeder funds and others allege that there were numerous "red flags" indicating that something was amiss at BLMIS.

Determining whether an investor's redemptions were limited to the principal also may be unclear for cases in which the investor did not invest directly with BLMIS. In the case of investments through the so-called feeder funds or other intermediaries, it may not be clear to the investor whether the fund or intermediary, from which the investor actually withdrew funds, had received false profits. Since some funds were invested almost entirely with BLMIS, they may not have sufficient funds to repay any false profits withdrawn from BLMIS. The Bankruptcy Code permits the Trustee to trace these false profits through any initial transferee to the ultimate recipient and seek return as a fraudulent conveyance. Accordingly, investors affected by Madoff who did not invest directly with BLMIS have a greater level of uncertainty than those who invested directly with BLMIS.

The final issue to keep in mind is the period of limitations applicable to these claims. The Bankruptcy Code permits the Trustee to look back two years from the date of filing, or to December 11, 2006. However, the Bankruptcy Code also permits the Trustee to utilize any applicable state law. In New York, where BMLIS was headquartered, the fraudulent conveyance statute permits the Trustee to look back 6 years, or all the way back to December 11, 2002. New York's look-back period is longer than many states. In Florida, where many Madoff investors reside, the look back period is 4 years. The BLMIS Trustee is seeking to take advantage of the longer period provided by New York law based on BLMIS' operation in New York. It is anticipated that disputes over the application of New York's statute to investors residing in other states will be hotly contested.

What to Expect

News accounts report that approximately 233 investors have received "clawback" requests from the BLMIS Trustee seeking the return of approximately $735 million that they withdrew before BLMIS collapsed. The BLMIS Trustee has indicated more letters likely will be sent out in the future. The BLMIS Trustee also has commenced suits against some of the hedge funds and their administrators that fed BLMIS, based on their withdrawal of substantial sums before BLMIS collapsed. It is anticipated that this is just the beginning of the litigation and that substantial additional activity will be seen before BLMIS' liquidation is completed.

If you have a client who was invested directly or indirectly with BLMIS, being aware of the potential for a clawback claim and assessing the likelihood of such a claim will be important to managing your client's expectation and your own exposure to risk. As an initial matter, you should determine whether the client withdrew any funds from the investment. If so, how recently? Making an assessment of whether your client withdrew more than he or she invested also is crucial. If these initial inquiries suggest your client is at risk for a clawback claim, you may want to consult an attorney or risk management professional to determine how to best avoid letting your client's problem become your problem.

There are many Madoff related issues that fall outside the scope of this article. If you have questions about other Madoff related issues, do not hesitate to contact an attorney or risk management professional. Inquiries also can be directed to the Philadelphia Insurance Company Loss Assistance Hotline at 877.742.2201 or http://apps.wilsonelser.com/pic.
