
TOPIC III: COMMON-LAW RESTITUTION AND PONZI SCHEMES

COMMON-LAW RESTITUTION AND THE MADOFF LIQUIDATION

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INTRODUCTION

In the aftermath of the greatest Ponzi scheme in history, involving thousands of victims and billions of dollars in losses, lawyers and judges have begun the task of “sorting out decades of fraud.”¹ The complex sorting process involves claims against multiple parties on a variety of legal theories, but the central feature of the Madoff controversy is readily apparent from newspaper accounts. As in any Ponzi scheme, purported investment returns were paid with money obtained from subsequent fraud victims. More fortunate investors – the “net winners” – withdrew more money from the scheme than they put in, while others – the “net losers” – withdrew less than they invested or nothing at all. A natural question is whether in these circumstances net winners are liable to net losers; if so, why, and to what extent.

An extensive body of law deals with precisely these questions, but that law is described in places where many modern lawyers and judges will not think to look. Rights and remedies between fraud victims are addressed by the common law of restitution and unjust enrichment, including (significantly) the

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¹ *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 231 (2d Cir. 2011).

equitable rights and remedies that make up much of this part of the law. Because the claims of net losers against net winners turn on textbook restitution issues, the Madoff liquidation is also the greatest restitution case in history, measured by the amounts at stake. A wave of Madoff litigation has begun to flow through the courts. But to judge by the published opinions in the cases so far, it appears that no one involved in these lawsuits – on either side of the bench – has thought to ask how the central issues would be analyzed and decided as a matter of common law. The significance of the law of restitution has been almost entirely overlooked.

The Madoff liquidation is taking place in a quasi-bankruptcy setting, and the courts' disregard of the underlying restitution questions is part of an increasingly familiar pattern. Bankruptcy law determines how property rights and claims of various parties are adjusted and reconciled, but it does not say what those rights are in the first place. Property interests, whether legal or equitable, are part of the state-law background on which the bankruptcy statutes impose a procedural overlay. Restitution claims of the kind asserted in bankruptcy typically involve equitable property interests: a category of property rights and associated remedies that began to recede from professional awareness when American law schools stopped teaching equity. The problem is that when lawyers no longer perceive the common-law background, they try to find statutory answers to questions the statutes do not address. The attempt necessarily distorts both the meaning of the statute and the rules of the background law that are being ignored.

At a minimum, the attempt to handle restitution claims in bankruptcy without reference to the background law by which they are defined means that the decisions reached on some central issues lack doctrinal coherence. Questions are made harder when relevant authority is ignored, and the doctrine in question – the law and equity of restitution and unjust enrichment – is impoverished where it might have been enriched.

Applying a statute without investigating its origins does not necessarily lead to wrong outcomes: courts may do the right thing for the wrong reasons, or for reasons that are imperfectly understood. In the Madoff cases, however, a failure so far to recognize the underlying nature of the claims of net losers against net winners carries potentially serious practical consequences. Two pre-trial rulings by the district court appear especially doubtful when the net losers' claims are recognized for what they are. One concerns the applicable statute of limitations: the difference this makes to the potential aggregate recovery is said to be in the billions of dollars.² Another – equally fundamental, though of less obvious economic significance – concerns the characterization of the restitution claims as legal or equitable for Seventh Amendment purposes. Both questions have been decided in a way that would

² See Peter Henning, *The Roller Coaster Ride Continues for Madoff Investors*, DEALBOOK (Oct. 3, 2011, 3:26 PM), <http://dealbook.nytimes.com/2011/10/03/the-roller-coaster-ride-for-madoff-investors-continues/>.

be plausible if the victims' claims had no existence outside the bankruptcy statutes. But if the underlying character of the victims' claims remains what it would be at common law – if those claims have not been transformed or supplanted by bankruptcy's procedural overlay – both decisions are open to serious question.

The highly visible case in which these rulings were first made was settled on the eve of trial,³ and further review of these questions will be significantly postponed.⁴ The questions are far from being settled, however, because hundreds of pending Madoff cases present the same legal issues. The common-law background of the Madoff liquidation offers reasons to think that some key issues have been wrongly decided, but a definitive answer necessarily depends on the relation between the relevant common-law background and its statutory overlay. This means that a definitive answer cannot be given by a court that does not have the common-law background clearly in view.

I. THE PROCEDURAL SETTING

Because the Ponzi in this case was Bernard L. Madoff Investment Securities LLC (BLMIS), a registered broker-dealer, the sorting process began with a temporary restraining order obtained on emergency application by the SEC, quickly supplanted by a “liquidation proceeding” under the provisions of the

³ See Memorandum of Understanding, *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011) (No. 11CIV3605(JSR)), 2012 WL 913560; Richard Sadomir & Ken Belson, *Mets' Owners Agree to Deal in Madoff Suit*, N.Y. TIMES, Mar. 19, 2012, at A1. Judging from news reports, the terms of the settlement appear largely consistent with the liability that common-law restitution would impose, though the court and the parties took a roundabout path to that outcome. The Trustee had claimed that the owners of the New York Mets took payments from BLMIS with notice of the fraud – an allegation which, if proven, would have left them liable in restitution for all payouts received after they obtained such notice. The district court had previously ruled that the question of “notice” in this context would be judged by the highly protective standard of “willful blindness,” rather than by any more moderate version of “reason to know.” See *Picard*, 462 B.R. at 454-56. This choice of a test for notice was not inevitable, but neither was it implausible. More controversially, the court had ruled that the “reach-back period” for which the Trustee could recover “fictitious profits,” without establishing notice on the part of the defendants, would be limited to two years rather than the six years for which the Trustee could probably obtain restitution at common law. *Id.* at 451-53. The basic settlement bargain thus appears to have been that the Trustee abandoned the attempt to show that the defendants had notice – including his potential appeal on the issue of the applicable legal standard – in exchange for the defendants' conceding their liability to repay six years of fictitious profits, not two. If the question of notice has been correctly resolved in their favor, this is the liability to which the defendants would be subject as a matter of common-law restitution.

⁴ The district court has already indicated that it is not inclined to certify its Madoff rulings for interlocutory appeal, *Picard v. Katz*, No. 11 Civ. 3605(JSR), 2012 WL 127397, at *1 (S.D.N.Y. Jan. 17, 2012), and the remaining cases are not “remotely as far advanced” as was *Picard v. Katz* at the time of settlement. *Id.* at *2.

Securities Investor Protection Act of 1970 (SIPA).⁵ The design of a SIPA liquidation borrows from the relevant provisions of the Bankruptcy Code, which govern it “[t]o the extent consistent with the provisions of this chapter,”⁶ and jurisdiction over a SIPA liquidation (as soon as essential preliminary steps have been taken) is assigned to the bankruptcy court.⁷ This statutory setting of the problem made it inevitable that the Madoff sorting process would take place within a quasi-bankruptcy framework, and that in each dispute about who should get less or pay more, the first response of lawyers and judges would be to argue that various provisions of SIPA and of the Bankruptcy Code supported one party’s claim or foreclosed another’s.

A purely statutory approach is ultimately inadequate, however, because the defining issues in the Madoff sorting process turn on questions of law that the statutes do not address. Yet these questions are not novel. They are the subject of an extensive body of American law, hidden in plain sight within the mainstream of common-law restitution.⁸ SIPA does not identify – let alone purport to displace – the basic propositions of common-law restitution that would guide the courts, in the absence of statutes, in sorting out decades of fraud on the facts presented. But the background rules cannot be applied if they are no longer recognized.

Everything about the Madoff liquidation is contested, including the facts, but the judicial decisions thus far proceed on the basis of certain simplifying assumptions about the operations of BLMIS.⁹ The first assumption is that the Madoff businesses may be cleanly segregated between fraudulent and non-fraudulent. BLMIS conducted three distinct businesses: an “investment advisory” business that operated the Ponzi scheme, as well as legitimate (but money-losing) “market making” and “proprietary trading” operations.¹⁰ While

⁵ See Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(b)(1), 84 Stat. 1647 (codified at 15 U.S.C. § 78fff (2006)).

⁶ 15 U.S.C. § 78fff(b).

⁷ *Id.* § 78eee(b)(4).

⁸ As used in this context, “common law” means “common law and equity,” while “restitution” refers to liabilities, remedies, and defenses based on unjust enrichment. Much of the following discussion uses the expression “common-law restitution” to describe claims and remedies that by historical standards are equitable rather than legal. The significance of the distinction is limited to the availability of jury trial – one issue in the Madoff case that appears to have been wrongly decided. See *infra* text accompanying notes 78-82. The use of the term “restitution” to refer to liabilities based on unjust enrichment was inaugurated by the original RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS (1937) and carried forward, despite misgivings, by the RESTATEMENT THIRD, RESTITUTION AND UNJUST ENRICHMENT (2011). On the problems with the name “restitution,” see *id.* § 1 cmt. e.

⁹ See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122, 126-32 (Bankr. S.D.N.Y. 2010), *aff’d*, 654 F.3d 229 (2d Cir. 2011).

¹⁰ *Id.* at 127.

the business units were “financially intertwined,” and revenues from the fraud may have been used to keep the legitimate businesses afloat, the assumption so far is that it is appropriate to treat them separately in reconstructing the workings of the Ponzi scheme.¹¹ The second assumption is that the investment advisory business was uniformly and radically fraudulent from its inception: that client funds were never invested in securities at all, being used solely “to support operations and fulfill other investors’ requests for distributions.”¹² Given these starting assumptions – which I adopt for purposes of this discussion – it follows that the relevant part of BLMIS had no legitimate revenues and no assets, other than money it obtained from its customers by fraud. It follows from this that any transfer of funds by BLMIS, including any withdrawal of funds by an investor, was necessarily paid with money obtained by fraud from subsequent victims. Except for the handful who may have known what was going on, every Madoff investor was a fraud victim, but the victims fared very differently: the net winners eventually withdrew more money from BLMIS than they put in, while the net losers withdrew less than their investments or nothing at all.

The Madoff liquidation has further ramifications, many involving issues that have nothing to do with unjust enrichment. But the heart of the matter is summed up in the circumstances just described. The defining issue in the case involves a restitution claim asserted either by or on behalf of one fraud victim against another. Someone who has been deprived of money by fraud has a *prima facie* entitlement in restitution to recover the money, not only from the initial (fraudulent) recipient but from subsequent transferees as well – subject, in the latter case, to important affirmative defenses.¹³ If the money of multiple fraud victims has been commingled, restitution recognizes (and limits) a claim to recover the commingled fund on behalf of the victims jointly.¹⁴ There is room for disagreement about some of the rules applied, but not about the starting premise, nor about the body of law in which such relationships are explored.

The decisions thus far put the relationship between net losers and net winners at the heart of the Madoff case, but the courts are attempting to analyze that relationship on the basis of statutes that do not address it. SIPA prescribes a process for the orderly recognition of customer claims against a broker whose customers are in need of protection,¹⁵ supplementing the assets otherwise available with “advances” from an industry-sponsored insurance entity, the Securities Investor Protection Corporation (SIPC).¹⁶ The rights and defenses of Ponzi victims *inter se*, when a Ponzi scheme happens to be

¹¹ *Id.* at 127-28.

¹² *Id.* at 128.

¹³ *See infra* text accompanying notes 24-25.

¹⁴ *See infra* text accompanying notes 67-70.

¹⁵ *See* 15 U.S.C. § 78eee (2006).

¹⁶ *See id.* § 78fff-3.

operated by a member of the SIPC, are addressed only by occult implication. SIPA was visibly drafted against a common-law background: restitution, not bankruptcy, is ultimately the source of the key provision by which a SIPA trustee is authorized to recover “customer property” from subsequent transferees.¹⁷ But few lawyers today will recognize the common-law principle behind the mechanical device by which the statute incorporates the restitution claim.

Statutes cannot resolve questions they do not address, but they can yield makeshift solutions. A round hole will take a square peg if you hit it hard enough. The most important contrivance of this kind in the Madoff context is the idea that a suit by a trustee to recover payouts from a Ponzi scheme is a claim to avoid a fraudulent transfer – or more precisely, that it can be treated as if it were one. The process that led to the adoption of this expedient is not hard to reconstruct. Ponzi schemes often wind up in bankruptcy. If the most significant creditors are the net losers in the scheme, and the most visible assets are their claims against net winners, a bankruptcy trustee will quickly see what needs to be done but will have a hard time finding explicit statutory authority to do it. Trustees and courts settled on “fraudulent transfer” as the least-bad fit, usually combining avoidance under Bankruptcy Code § 544(b)(1) with state-law remedies for fraudulent transfer.¹⁸ The idea of treating a customer’s restitution claim as if it were an action to avoid a fraudulent transfer was adopted by SIPA in relatively candid terms, since SIPA expressly acknowledges that the fraudulent-transfer solution depends on “deeming” the relevant transactions to be something other than what they actually were.¹⁹ The relevant language of SIPA was copied into subchapters 3 and 4 of Bankruptcy Code chapter 7, for use in the liquidation of stockbrokers and

¹⁷ *Id.* § 78fff-2(c)(3).

¹⁸ We get a glimpse of the process by which statutes replaced the common law in professional thinking in the simple case of *Conroy v. Shott*, 363 F.2d 90, 91 (6th Cir. 1966) (“The bankrupt inaugurated a [fraudulent] scheme wherein he would borrow a sum of money from A, then borrow from B to repay A, borrow from C to repay B and so on.”). Ultimately, “some 120 or more people made loans to the bankrupt in widely varying amounts, aggregating \$3,309,462.05.” *Id.* Payouts totaling \$1,343,410 had been made to one investor who had notice (if not knowledge) of the fraudulent scheme. *Id.* The trustee naturally sought to recover these funds on behalf of the net losers, claiming authority (first) on the basis of § 70(e)(1) of the Bankruptcy Act of 1898 (the predecessor of 11 U.S.C. § 544(b)(1) (2006)) and (second) on Ohio’s statutes on fraudulent transfer. *See id.* at 91-92. Reasoning that “‘an intent to defraud on the part of [the debtor] must first be presumed to have existed’” in any Ponzi scheme, the district court concluded that there was a right to avoid the payouts under Ohio law and therefore in bankruptcy as well. *See id.* at 92 (quoting the district court opinion). That being the case, it became unnecessary “‘to consider the unjust enrichment theory debated by counsel.’” *Id.* at 92-93 (quoting the district court opinion).

¹⁹ See 15 U.S.C. § 78fff-2(c)(3), set forth *infra* in text accompanying note 66.

commodities brokers.²⁰ The same expedient – that of referring to a Ponzi payout as if it were a fraudulent transfer – has become the generally accepted way to describe an action by which any representative of Ponzi victims, including an equity receiver outside bankruptcy, recovers payouts to net winners for the benefit of net losers.²¹

Deeming the Ponzi payout to be a fraudulent transfer is an approximation that can be made to serve, but it fails as a plain-language description of what is going on. If we give the central claim in the Madoff liquidation its most accurate legal description – instead of forcing it into the nearest bankruptcy pigeonhole – the relation between the governing statutes and their common-law background will have to be rethought.

II. NET LOSERS VS. NET WINNERS AT COMMON LAW

In August 2011, the American Law Institute finally published its *Restatement Third, Restitution and Unjust Enrichment* (R3RUE). Despite the implications of the title – there was no *Restatement Second* of this subject – R3RUE is the first ALI treatment of the law of restitution since the original *Restatement of Restitution* gave the field its modern definition in 1937. There is a stiff price to be paid for these decades of neglect. The name “restitution” itself has been hijacked by people who use it to refer to all sorts of things other than unjust enrichment, such as compensatory damages payable by criminals to their victims.²² Meanwhile, some classic examples of claims and remedies in restitution now go by the name “clawback” – not a search term that will lead you quickly to the law of the subject.²³ Problems of terminology are merely one indication of a broader challenge facing R3RUE. If restitution has receded from professional awareness to the point that even lawyers dealing with a core case of restitution no longer see what it is, a new Restatement of the subject will not be of much use.

²⁰ 11 U.S.C. §§ 749, 764 (2006).

²¹ For recent nonbankruptcy cases in which a suit by a receiver to recover Ponzi payouts from net winners is characterized as an action to avoid a fraudulent transfer by the swindler, see, for example, *Janvey v. Alguire*, 628 F.3d 164, 182-83 (5th Cir. 2010), *Donell v. Kowell*, 533 F.3d 762, 767 (9th Cir. 2008), and *Janvey v. Democratic Senatorial Campaign Committee, Inc.*, 793 F. Supp. 2d 825, 828 (N.D. Tex. 2011).

²² See, e.g., 18 U.S.C. § 3663A (2006) (mandating court orders of “restitution” to victims of certain defined crimes).

²³ The term “clawback” appears to have originated in England, where it is most commonly used to describe retroactive adjustments of tax liability. Within the last few years it has come to be employed by U.S. lawyers as a more vivid way to say “restitution,” particularly where the claim is one to recover money payments involving fraud or mistake. A claim to recover distributions of fictitious Ponzi profits makes a perfect example of this new usage. Another is a claim to recover bonus payments to corporate executives based on nonexistent earnings. See, e.g., *Hampshire Grp., Ltd. v. Kuttner*, No. 3607-VCS, 2010 WL 2739995, at *3 (Del. Ch. July 12, 2010).

R3RUE is not the last word on the subject, but it provides a reliable indication of the way the common law would sort out decades of fraud in the Madoff liquidation. This is because the central claims and defenses – approached as a problem of unjust enrichment – are simple and well understood.

Restitution between fraud victims begins with a three-party transaction. By fraudulent misrepresentations, Swindler obtains \$1000 from Victim 1. Deciding later to repay him (perhaps V1 has begun to ask for his money back), Swindler obtains \$1000 by a new fraud from Victim 2 and uses this money to repay V1. Swindler now disappears and drops out of the story. When the facts come to light, V2 has a restitution claim for \$1000 against Swindler. V2's restitution claim is distinct from a contract claim or a tort claim, which V2 might possibly have as well; the essence of restitution in this context is that – rather than enforcing a debt or seeking damages for deceit – V2 is rescinding (bankruptcy would say “avoiding”) the transaction with Swindler to recover what in equity is “his” property. Of course the restitution claim against Swindler is worthless, as are the contract and tort claims. But restitution has a transitive feature that these other claims do not. A person who is deprived of property by fraud (or other circumstances giving rise to a claim in unjust enrichment) can follow the property through the hands of successive transferees and recover it from anyone in whose hands he can find it.²⁴ This much is true *prima facie*, but the affirmative defense of bona fide purchase is such an important part of the story that it is misleading to describe the claim without the defense. So what the cases usually say is that a person who is deprived of property by fraud can follow his property through successive transfers and recover it from anyone in whose hands he can find it, so long as the defendant/transferee does not qualify as an innocent purchaser for value.²⁵

This description of the claim should sound familiar to bankruptcy lawyers, because each step of the analysis *except the first* is found in Bankruptcy Code § 550, “Liability of transferee of avoided transfer.”²⁶ Section 550 is surely the most restitution-minded section of the Code: it not only embodies the notion of following property through successive transfers and the defense of purchase for value, but it goes so far as to anticipate a remedy by equitable lien for innocent transferees who have made expenditures (paying for things like taxes or improvements) to benefit property that now turns out to be owned by someone else. Each of these ideas is solidly grounded in common-law

²⁴ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 13, 58(2) (2011); *see also id.* § 41 (specifying that “[a] person who obtains a benefit by misappropriating financial assets, or *in consequence of their misappropriation by another*, is liable in restitution to the victim of the wrong” (emphasis added)).

²⁵ *Id.* § 58(2).

²⁶ *See* 11 U.S.C. § 550 (2006).

restitution, but running them all down through R3RUE requires references to half a dozen different sections.²⁷

The reason that § 550 does not supplant common-law restitution in a Ponzi case is that the initial step is missing: namely, V2's right to rescind or avoid his transaction with the debtor, based on the debtor's fraud. A claim of that kind is one that bankruptcy leaves to the common law. This point bears some emphasis, because it is a distinction that current bankruptcy practice tends to lose sight of. While V2 presumably has a "claim" against the debtor by the bankruptcy definition, making him a "creditor" in the debtor's bankruptcy,²⁸ V2's significant claim in this context is neither the contract claim of a creditor against a debtor nor the tort claim (for misrepresentation) of a fraud victim against a swindler. Rather, it is the restitution claim of a fraudulently dispossessed owner to retake his identifiable property. The usual version of such a claim in a bankruptcy context involves a voidable pre-petition transfer by the claimant to the debtor, such as a transfer induced by the claimant's mistake or the debtor's fraud. Restitution in such a case takes the form of an adversary proceeding in which the claimant attempts – by asserting rights in common-law restitution – to recover his property from the bankruptcy trustee. This is the kind of claim that often degenerates into an argument about whether "[c]onstructive trusts are anathema to the equities of bankruptcy."²⁹ In the Madoff context, the fact that V2's assets are in the hands of V1 – not a trustee who is trying to preserve them for unsecured creditors – means that this routine version of the argument over restitution in bankruptcy is not going to arise.³⁰

Returning to our starting point, V2 will have to prove that V1 was repaid with "his" money to show that V1 has been unjustly enriched at V2's expense. There are various ways V2 might do this, mostly involving the "tracing rules" – the best known of which is the rule of "lowest intermediate balance."³¹ Here the notable feature of the Madoff liquidation is the fact that, on the assumptions we have adopted, *every* dollar paid by Madoff to V1 (or anyone else) was necessarily a dollar obtained by fraud from V2. This being the case, V2's prima facie claim in restitution is fully made out. V2's restitution claim would be the same against a subsequent transferee from V1, though such a claim is not worth thinking about unless the subsequent transferee took the

²⁷ See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 58 ("Following Property Into its Product and Against Transferees"); *id.* § 66 ("Bona Fide Purchaser"); *id.* § 67 ("Bona Fide Payee"); *id.* § 68 ("Value"); *id.* § 69 ("Notice"). On the lien allowed to the dispossessed transferee, see *id.* § 27 ("Claimant's Expectation of Ownership"), and § 56 ("Equitable Lien").

²⁸ See 11 U.S.C. § 101(5), (10).

²⁹ *XL/Datacomp, Inc. v. Wilson (In re Omegas Grp., Inc.)*, 16 F.3d 1443, 1452 (6th Cir. 1994).

³⁰ On the general problem of restitution in bankruptcy associated with *Omegas Group*, see RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 60 reporter's note cmt. f.

³¹ See *id.* § 59.

money with notice of the fraud, without giving value, or both. Examples in the Madoff context might include people to whom net winners made gifts of money withdrawn from BLMIS, such as family members or charities.

Restitution now shifts its focus to examine V1's possible defenses. Most prominent is the defense of bona fide purchase, or what R3RUE calls "bona fide payee" when the contested transfer is a money payment.³² To be entitled to this or any other defense, V1 must show that he took V2's money without notice that it was the product of Swindler's fraud. (This notice requirement has been paraphrased by modern statutes, including the Bankruptcy Code, as a requirement of "good faith"; but "good faith" in this context *means* "without notice."³³) "Notice" is "knowledge or reason to know,"³⁴ but judicial views of what constitutes "reason to know" vary with the different situations in which the question is presented. Answers extend along a range beginning somewhere around "circumstances that would lead a prudent purchaser to conduct further inquiry" and ending in the neighborhood of "willful blindness."³⁵ The impossibility of specifying a test of notice that is satisfactory in all cases makes this aspect of a restitution claim one of the most controversial. It does not arise uniformly in the Madoff context, because there is no contention that the typical net winner had knowledge or reason to know of the ongoing fraud. Notice is a key issue, by contrast, in proceedings by which the trustee is attempting to recover funds paid out to Madoff family members or to sophisticated investors who allegedly ignored warning signs of the fraud.

If V1 is a payee without notice, he can take the \$1000 free of V2's restitution claim if and to the extent he gives value for the payment.³⁶ The "value" requirement presents no difficulty in cases of ordinary creditors and sales for present value. (As Lord Mansfield explained, the goldsmith can retain the £500 he receives for his goods, even if it turns out that he was paid with stolen money.³⁷) By the majority rule, any ordinary creditor whose claim is satisfied or reduced with money obtained from a third party by fraud or mistake is likewise entitled to keep the payment free of the third party's restitution claim, to the extent the claim satisfied was a valid one.³⁸ Thus V1 would unquestionably have a defense against V2 if V1 had received the \$1000 payment as Swindler's trade creditor or lender. The result is the same even if we say that the money in question was "stolen" from V2.

³² See *id.* § 67.

³³ See *id.* § 66 cmt. d.

³⁴ See *id.* § 69.

³⁵ For the range of possibilities, some specified by statute, see the comments and notes to *id.* § 69. For contrasting positions adopted in recent Ponzi bankruptcies, compare *SEC v. Forte*, Nos. 09-63, 09-64, 2009 WL 4809804, at *6 (E.D. Pa. Dec. 15, 2009) ("inquiry notice"), with *Picard v. Katz*, 462 B.R. 447, 456 (S.D.N.Y. 2011) ("willful blindness").

³⁶ See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 68.

³⁷ *Miller v. Race*, (1758) 97 Eng. Rep. 398, 402 (K.B.); 1 Burr. 452, 459.

³⁸ See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67.

The fact that V1 and V2 are both fraud victims – and that V1 is not a creditor of Swindler in the ordinary course – has traditionally made V1’s resort to the standard defense problematic. V1’s right to *restitution* from Swindler is a right to rescind, not to enforce. Courts that were inclined to allow restitution to V2 sometimes reasoned (particularly in cases of forgery and imposture) that V1 was not in fact anyone’s creditor, he only thought he was.³⁹ To sidestep this controversy, R3RUE adopts the consensus view that, while V1 may or may not be regarded as a “creditor” of Swindler in a particular case, he has an inchoate restitution claim against Swindler for the money obtained from him by fraud and that the satisfaction or reduction of this inchoate claim is properly treated as value. R3RUE accordingly provides as follows:

§ 67. Bona Fide Payee.

(1) A payee without notice takes payment free of a restitution claim to which it would otherwise be subject, but only to the extent that

(a) the payee accepts the funds in satisfaction or reduction of the payee’s valid claim as creditor of the payor or of another person; [or] . . .

(c) the payee’s receipt of the funds reduces the amount of the payee’s inchoate claim in restitution against the payor or another person.⁴⁰

Standing alone, this statement of the rule might appear to invite an argument by Madoff net winners that they accepted all funds withdrawn, including fictitious profits, “in satisfaction or reduction of [a] valid claim as creditor” of BLMIS. The answer is that a Madoff victim does not have a “valid claim as creditor,” either in contract or in tort, to the imaginary returns on an investment that was never made. That conclusion is relatively easy to reach in a case where no particular return on investment has been promised.⁴¹ A more

³⁹ See Andrew Kull, *Defenses to Restitution: The Bona Fide Creditor*, 81 B.U. L. REV. 919, 942-45, nn.65-76 (2001) (citing cases).

⁴⁰ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67(1). The omitted § 67(1)(b) deals primarily with cases of payment of an unenforceable instrument, to accommodate inter alia the rule of *Price v. Neal*, (1762) 97 Eng. Rep. 871 (K.B.); 3 Burr. 1354 (Mansfield, L.J.).

⁴¹ Discussing the remedies for fraud in the inducement – beyond the obvious refusal to enforce such a contract against the victim – Williston identifies (1) damages for deceit, (2) rescission and restitution, and (3) “[e]nforcement against the fraudulent person of the kind of bargain which he represented that he was making.” 12 WILLISTON, LAW OF CONTRACTS § 1523 (3d ed. 1970). This third remedy is said to be available in “at least two classes of cases”: (a) contracts for the sale of goods, in which a fraudulent misrepresentation of quality or value may be treated as a warranty, and (b) cases in which one party’s fraudulent misrepresentation of the terms of a written contract may be remedied by reforming the contract to provide what it was said to provide. *Id.* The U.C.C. codifies the defrauded buyer’s right to treat as a warranty a misrepresentation by the seller of goods, U.C.C. § 2-721 (2000), but “the implied warranty theory is not usually available except to the plaintiff who purchases tangible chattels.” 2 DOBBS, LAW OF REMEDIES § 9.1 (2d ed. 1993).

difficult question is presented when the essence of a Ponzi scheme is a fraudulent promise of high fixed returns, paid out to net winners who do not have notice that their return on investment is too good to be true. In the R. Allen Stanford Ponzi scheme, investors purchased certificates of deposit issued by Stanford's Antigua bank. Funds to pay above-market interest and to redeem the CDs came from purchases by subsequent fraud victims. In litigation about the continuation of a freeze order covering certain customer accounts, the Stanford receiver (over the objections of the SEC) sought to recover *both* principal and interest paid out to Stanford's earlier investors, eliminating altogether the defense of bona fide payee to achieve a purely ratable recovery. The district court (by maintaining a partial freeze) implied that the receiver might recover interest but not principal; the Fifth Circuit (by dissolving the freeze) implied that the net winners could retain interest as well.⁴²

A fraud victim who proceeds in tort, seeking damages for misrepresentation (deceit), encounters a well-known split between "out of pocket" and "benefit of the bargain" measures of damages in fraud cases. *See id.* § 9.2(1). An entitlement to tort damages measured by "benefit of the bargain" may be indistinguishable, as a practical matter, from a claim in contract to enforce a fraudulent promise. But the availability of "benefit of the bargain" damages depends on the nature of the fraud, and the logic of the remedy tends to restrict it to cases of warranty-like misrepresentations by sellers to buyers. *See id.*

One hypothetical way to test the extent of a Madoff investor's "valid claim as creditor" is to imagine what would happen if the liquidation were a straight bankruptcy case, ignoring both V2's restitution claim and the calculation of "net equity" directed by SIPA. *See infra* text accompanying notes 52-56. A threshold issue would then be the amount of each investor's allowable claim against the debtor (defined as a "right to payment," Bankruptcy Code, 11 U.S.C. § 101(5) (2006)) under applicable state law. Whether the investor's claim is seen as arising in contract or tort, and whether the jurisdiction usually awards "out of pocket" or "benefit of the bargain" damages in fraud cases, it is safe to assume that allowable claims would *not* be calculated on the basis of fictitious balances reported in fraudulent brokerage statements. *See, e.g.,* Official Cattle Contract Holders Comm. v. Commons (*In re* Tedlock Cattle Co.), 552 F.2d 1351, 1353 (9th Cir. 1977).

⁴² *See* Janvey v. Adams, 588 F.3d 831, 833, 835 (5th Cir. 2009). The remedial alternatives thus canvassed make *Janvey v. Adams* a perfect case with which to test the meaning of R3RUE § 67(1)(a) on this point, and the decision of the Fifth Circuit is potentially significant authority on this difficult issue of restitution. Unfortunately, the opinion in *Janvey* is as oblivious to the common-law setting of the problem as the more recent opinions in the Madoff cases. Failing to recognize that the Stanford net winners – if denied an affirmative defense – might be liable to net losers in restitution, the court explains that they are "relief defendants." *See id.* at 833. According to what the court calls "this 'obscure common law concept,'" a "relief defendant," though "not accused of wrongdoing," may nevertheless be liable "to aid the recovery of relief" when the relief defendant "(1) has received ill-gotten funds, and (2) does not have a legitimate claim to those funds." *Id.* at 834 (citations omitted) (quoting Commodity Futures Trading Comm'n v. Kimerlynn Creek Ranch, Inc., 276 F.3d 187, 191 (4th Cir. 2002)). It would be hard to find a better example of the process by which equitable wheels have to be reinvented by modern courts that have

If the text of § 67(1)(a) leaves any room for doubt about this distinction, it betrays a failure by the ALI's Reporter to anticipate all possible applications of the language in question to a profitable investment in a fraudulent scheme. But whatever the shortcomings of R3RUE's "black letter" provision, the comments and illustrations accompanying § 67 make it explicit that fraud victims who withdraw funds from Ponzi schemes are allowed an affirmative defense as bona fide payees only to the extent of their net investments:

The most notable applications of § 67(1)(c) concern the ostensible proceeds or profits of fraudulent investment schemes involving multiple victims. The basic proposition may be observed in a case involving only two victims . . . but its more important consequences are seen in the large-scale investment frauds known as Ponzi schemes. It may be assumed for purposes of exposition that hundreds or thousands of victims have invested funds in such a scheme; that all these investors were alike defrauded; and that some earlier or luckier investors have received money paid out of the scheme before the fraud is revealed, while others have lost their entire investment. . . . 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.

Assuming further that the flow of funds within the investment scheme is untraceable (so that no investor is able to assert a prior claim to any identifiable asset within a commingled fund), and moreover that the wrongdoer has not contributed any legitimate assets to the fraudulent scheme, it follows that every dollar paid out to any investor – whether characterized as interest, dividends, profits, or return of capital – comes from funds obtained by fraud from subsequent investors. Each dollar paid out is therefore subject to restitution in favor of the fraud victims as a group (§§ 13, 41), except insofar as a particular recipient may be entitled to an affirmative defense.

The rule of § 67(1)(c) allows a defrauded investor without notice to retain payments received from the commingled fund, but only to the extent that such payments reduce the amount of the investor's inchoate restitution claim against the wrongdoer. The effect of this rule is that an innocent payee may retain withdrawals or distributions up to the amount of his investment, but is liable in restitution for anything more. As in every case within the present section, the availability of a defense depends on the payee's lack of notice. See Illustrations 17-19.

Illustrations:

17. Investor A deposits a total of \$610,000 with Broker for purposes of commodities trading. Broker furnishes periodic statements reflecting purported trades and substantial gains, showing a steadily increasing balance in A's account. The statements are false. Broker is

operating a Ponzi scheme, reporting nonexistent trades and profits, financed by the deposits of subsequent investors. By the time of Broker's eventual collapse, A has received a total of \$585,000 in distributions. Claims of those who have lost money in Broker's scheme far exceed the assets available for distribution, and Receiver is appointed to seek restitution on behalf of the injured investors. Receiver offers proof that all distributions to Investor were made with funds obtained from subsequent fraud victims and demands restitution of \$585,000 on theories of unjust enrichment and constructive trust. The court finds that A received these distributions without notice of Broker's fraud or insolvency, and that A sustained a net loss of \$25,000 in his dealings with Broker. A is not liable to Receiver in restitution. A is entitled to seek recovery of his \$25,000 loss, *pari passu* with the claims of other defrauded investors.

18. Investor B has the same experience as Investor A in Illustration 17, except that Investor B has received a total of \$900,000 in distributions from a \$500,000 investment. (Above and beyond these distributions, Broker's final statement shows a fictional closing balance of \$600,000 in B's account.) Notwithstanding the fact that B received the distributions without notice of Broker's fraud or insolvency, B's defense under this section is limited to \$500,000. Receiver is entitled to restitution of \$400,000 on behalf of injured investors – a class that does not include B.⁴³

The basic contours of the claim of a net loser against a net winner at common-law restitution should now be clear, though a few additional details must be noted. R3RUE § 67 recognizes an affirmative defense to the extent of the payee's "inchoate claim in restitution" (that is, V1's restitution claim against Swindler). Common-law restitution measures V1's claim against Swindler by the extent of Swindler's unjust enrichment at V1's expense: for this purpose, Swindler's enrichment from the transaction with V1 includes interest at market rates.⁴⁴ At a minimum, Madoff net winners would thus be allowed at common law to retain their net investment plus interest. And while the defense allowed to a bona fide payee will predominate in most claims by V2 against V1, it is not the only significant defense to a restitution claim. So long as V1 is without notice of the fraud, V1 can also defend V2's claim by

⁴³ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 cmt. f. For further discussion of Ponzi investors as bona fide payees, see *id.* § 67 cmt. i. The reporter's note to § 67 indicates that illustrations 17-18 are based on a nonbankruptcy case, *Chosnek v. Rolley*, 688 N.E.2d 202 (Ind. Ct. App. 1997), and on such bankruptcy decisions as *Eby v. Ashley*, 1 F.2d 971 (4th Cir. 1924) (described as "the leading case"), *Scholes v. Lehmann*, 56 F.3d 750, 757-58 (7th Cir. 1995), and *Wyle v. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 595 (9th Cir. 1991). For a more recent decision to the same effect, see *Perkins v. Haines*, 661 F.3d 623, 627 (11th Cir. 2011).

⁴⁴ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 53.

showing a detrimental change of position in reliance on the payment that V2 seeks to recover.⁴⁵ V1 could readily establish a change of position by proving, for example, that receipt of the funds in question had led him to make a gift to charity that he otherwise would not have made. And while standard restitution doctrine resists the idea that expenditures for ordinary living expenses (or for the repayment of obligations) can qualify as a change of position, there is room in the cases for an argument that a significant lapse of time, combined with evident hardship in requiring repayment of money the recipient no longer has readily available, can be grounds for recognizing a defense of change of position or “changed circumstances.”⁴⁶ Such considerations would have an obvious bearing on restitution claims against Madoff net winners whose present circumstances make a repayment obligation particularly burdensome.

A final aspect of common-law restitution between fraud victims comes into view when we expand the three-party molecule (V2 – Swindler – V1) to a full-blown Ponzi scheme involving numerous victims. When the music stops and the sorting process begins, orthodox restitution initially allows each fraud victim to retake his own property if he can identify or “trace” it among the assets in the hands of the swindler. (A simple example would be a case in which one victim’s registered securities were still sitting untouched in Swindler’s safe deposit box, while other victims’ securities had been sold for cash which was then commingled in Swindler’s bank account.) When the means of identification fail – as they quickly will when investments are made in cash – the property of multiple fraud victims becomes a “commingled fund” in which victims share in proportion to their respective losses.⁴⁷ The distinction is critical to those Ponzi cases in which some victims can “trace” and others cannot. It would seem to be irrelevant to the Madoff liquidation, given the assumption that victims’ funds were immediately commingled in a single BLMIS bank account.⁴⁸

Recent Ponzi cases involving the tracing issue are nonetheless significant to the Madoff liquidation, because they reveal the present inclination of federal courts, in a series of decisions since the 1990s, to impose a ratable distribution of fraud losses between Ponzi victims similarly situated. The strength of this inclination can be fully appreciated only when it is understood that courts are now willing to ignore the existing (and previously undisputed) common law of tracing to achieve what they regard as a more equitable outcome. Clearly, the fact that one victim is able to trace his property while another cannot may be

⁴⁵ *Id.* § 65.

⁴⁶ *See id.* § 67 cmt. c (“Particularly after substantial time has elapsed, a court may conclude that the imposition of a present obligation to repay money long since spent would be inequitable to the recipient . . .”).

⁴⁷ *Id.* § 59(4). The pertinent text is set forth *infra* in text accompanying note 67.

⁴⁸ *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122, 129 (Bankr. S.D.N.Y. 2010), *aff’d*, 654 F.3d 229 (2d Cir. 2011).

entirely fortuitous; worse (in the opinion of many judges), it may depend on arbitrary choices made by Swindler. Courts have responded by announcing that the availability of tracing remedies is a matter of equitable discretion and that such remedies are properly disallowed if their effect would be to allow some Ponzi victims a disproportionate recovery. Judged by traditional authority (including that of Chief Justice Taft in the original Ponzi case⁴⁹), this characterization of tracing as discretionary is plain error; but it is a pervasive and recurrent error that reveals the strength of the present judicial commitment to ratable recovery.⁵⁰ If the Madoff liquidation were being carried out under different auspices – for example, in a federal court receivership instituted on suit by the SEC – it is safe to predict that “ratable allocation of fraud losses” would be the beginning and the end of the legal story.

Ratable recovery between victims of a common fraud cannot be quite the end of the story, however, because it is flatly inconsistent with the standard defense allowed the bona fide payee. By the rule of R3RUE § 67, an earlier or simply luckier fraud victim who invests \$1000, then withdraws \$1000 (or any lesser amount), will be allowed to retain the withdrawal free of his fellow victims’ restitution claims – thereby recovering a greater proportion of his losses, if indeed he does not avoid them altogether. To make ratable recovery the ultimate rule of decision in Ponzi cases, therefore, it might seem necessary to eliminate altogether the affirmative defense of the bona fide payee. Absent this defense, *every* recipient of a payment from the commingled fund would be prima facie liable to restore all of it, creating a hotchpot from which all victims might then recover in proportion to their losses. The courts do not go this far, though at least one receiver in a recent Ponzi case has argued that they should.⁵¹ But the defense of the bona fide payee is too firmly entrenched – in part by statutes such as Bankruptcy Code § 548(c), allowing the defense to the recipient of a fraudulent transfer – to contemplate a pure regime of ratable recovery. Of course, the same inconsistency might be used in converse fashion to argue that ratable recovery, despite what the judges say, is not and cannot be the paramount consideration in sorting out Ponzi cases.

⁴⁹ See *Cunningham v. Brown*, 265 U.S. 1, 11 (1924).

⁵⁰ The departure from traditional authority is noted and criticized at RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 59 cmt. g and the accompanying reporter’s note. Appellate decisions, increasingly numerous, that disallow tracing in favor of ratable recovery between Ponzi victims include *United States v. Ramunno*, 599 F.3d 1269, 1275 (11th Cir. 2010), *United States v. Andrews*, 530 F.3d 1232, 1238 (10th Cir. 2008), *SEC v. Infinity Group Co.*, 226 F. App’x 217, 219 (3d Cir. 2007), *SEC v. George*, 426 F.3d 786, 799 (6th Cir. 2005), *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002), *United States v. Real Property*, 89 F.3d 551, 553 (9th Cir. 1996), *United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996), and *SEC v. Elliott*, 953 F.2d 1560, 1569-70 (11th Cir. 1992).

⁵¹ See *supra* note 42 and accompanying text.

III. MADOFF IN THE COURTS

On August 16, 2011, the Court of Appeals for the Second Circuit affirmed an order of the Bankruptcy Court for the Southern District of New York, approving the trustee's method for determining the amount of a Madoff customer's "net equity."⁵² SIPA defines "net equity" as the value on the filing date of a customer's "securities positions" less the customer's indebtedness to the broker.⁵³ Customers of a broker in liquidation "share ratably" in "customer property" assembled or recovered by the trustee, "on the basis and to the extent of their respective net equities."⁵⁴ A customer whose "net equity . . . exceeds his ratable share of customer property" can recover the shortfall from the SIPC, up to the amount of \$500,000.⁵⁵

The question before the Second Circuit was how "net equity" should be measured in the Madoff context. The trustee – with the approval of the SIPC, the SEC, and the bankruptcy court – proposed to measure net equity by each customer's net investment with Madoff: deposits less withdrawals. Appellants, a group of net winners, argued that the value of their "securities positions" (the basis of the net equity calculation) was the value of their fictitious accounts as reported in their most recent brokerage statements. Because every Madoff investor received statements reflecting regular, nonexistent profits, calculating securities positions based on this "last statement method" would mean that every investor had "net equity" – in other words, that every investor (including the net winners) incurred a loss when BLMIS failed. Increasing aggregate net equity reduces each customer's ratable share of the customer property available to meet customer claims. The consequence would be to increase the losses of the net losers to improve the position of the net winners – customers who have already seen a profit from their investment with Madoff.

There are many reasons to reject such an outcome, and the Second Circuit mentioned several – including statutory fine print, fairness, and ad hoc policy considerations. But the court overlooked what by conventional standards should be the single most cogent argument for its position. Once it is recognized (and the court clearly did recognize) that the definition of "net equity" governs the claims of net losers and net winners *inter se*, it should be a short step to the view that – language permitting – SIPA should be interpreted in a manner consistent with the preexisting body of law by which these rights and obligations are governed. Measuring net equity by net investment in the Madoff context makes the resulting distribution exactly congruent with the common law of the situation, because it allocates a commingled fund (what SIPA calls "customer property") ratably in proportion to investor losses. This

⁵² *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 242 (2d Cir. 2011), *aff'g* 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

⁵³ *See* 15 U.S.C. § 7811l(1) (2006).

⁵⁴ *Id.* § 78fff-2(c)(1); *see also id.* § 7811l(4) (defining "customer property"); *id.* § 7811l(1) (defining "net equity").

⁵⁵ *Id.* § 78fff-3(a).

is what the law of restitution dictates, and it yields the ratable recovery that courts impose in Ponzi liquidations in all other contexts.

The implications of the common-law analogy go further than that. The amount of “customer property” available for distribution will depend to a large extent on suits by the Madoff trustee to recover funds previously withdrawn from the scheme. If it is recognized that an adversary proceeding of this kind is essentially a restitution claim by a fraud victim against a subsequent transferee of the property in question – the claim previously described as V2 v. V1 – it is immediately apparent that net winners are potentially defendants but not claimants. It is difficult to visualize a process by which the trustee would be distributing “customer property” to net winners with one hand while suing them to recover “customer property” with the other.⁵⁶

If the criticism of the Second Circuit opinion were merely that the court neglected to identify the best reasons for deciding as it did, there would be little point in pursuing the discussion. But the failure to put the dispute in its common-law context carries serious implications for the way the Madoff liquidation is being handled in other respects. Once we see that the rights of Madoff customers *inter se* are a problem squarely addressed by common-law restitution, we can see that the applicable statutes neither identify those rights nor purport to displace them. It follows that the statutes should be interpreted so far as possible in a manner consistent the preexisting law of the subject. If bankruptcy respects state-law entitlements, except as these are necessarily displaced in favor of overriding bankruptcy policy, then the established rights of the Madoff net losers at common law must be a decisive consideration in applying the statutes. But it is impossible to judge the proper relation between statutory overlay and common-law background if we are unable to make out the background to begin with.

The stakes in the Madoff context are very high. The SIPA trustee for BLMIS, Mr. Irving Picard, has initiated more than a thousand adversary proceedings to recover assets for distribution to Madoff customers, alleging

⁵⁶ Net winners argue, in effect, that the SIPC insurance fund protects them against any shortfall (subject to a \$500,000 limit) in realizing the “securities positions” reflected on their brokerage statements, whatever the reasons for the shortfall. *See, e.g., In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 239 (“The BLMIS claimants characterize the overall statutory scheme as an insurance guarantee of the securities positions set out in their account statements.”). The risk that a financially troubled broker might have converted a customer’s securities, or never purchased them at all, is presumably within the intended coverage of SIPC insurance. Whether the SIPC insures the reality of the wholly fictitious securities positions in the Madoff context is another question. This aspect of the dispute involves a contract claim and a question of statutory interpretation having nothing to do with the law of unjust enrichment, and the scope of SIPC insurance might be fairly debatable if the issue could be considered in isolation. It cannot, because the same definition of “net equity” controls both the customer’s entitlement to SIPC advances (15 U.S.C. § 78fff-3(a)) and the allocation of “customer property” – and thus of fraud losses – between customers (§ 78fff-2(c)(1)(B)).

wrongful conduct (for which he seeks damages), theories of avoidance (such as fraudulent transfer), or both. The U.S. District Court for the Southern District of New York has since withdrawn the reference to the bankruptcy court of some of these adversary proceedings to determine what it described as unresolved issues of non-bankruptcy federal law.⁵⁷ In subsequent proceedings, the district court has made rulings less favorable to the Madoff trustee than previous rulings of the bankruptcy court and in some respects has contradicted those previous rulings. Most significantly, the district court held that Bankruptcy Code § 546(e) – the so-called safe harbor for “settlement payments” made by or to financial institutions – barred all avoidance claims by the Madoff trustee other than those based on § 548(a)(1)(A) (alleging fraudulent transfer with “actual intent” to defraud).⁵⁸ Section 548(a)(1) incorporates a two-year reach-back period; state-law claims that might otherwise be asserted under § 544(b)(1) would in all likelihood permit a reach-back period of not less than six years.

The scope of § 546(e) is notoriously controversial.⁵⁹ But even if we give the provision its broadest possible application to shelter unperfected, fraudulent, or preferential transfers by “financial institutions” in respect of actual “securities contracts,” it would still be reasonable to ask whether the safe harbor is properly applied to limit the recapture of distributions from a Ponzi scheme. Some courts have held that it is not.⁶⁰ So did the bankruptcy court in another one of the Madoff lawsuits, only five days before the district court issued its contrary ruling.⁶¹

Applying a two-year rather than a six-year reach-back period to the trustee’s restitution claims will significantly reduce the funds recoverable for the benefit of net losers, reportedly by as much as \$6 billion. Such a radical displacement of valid state-law entitlements (the net losers’ common-law restitution claims on the model of V2 v. V1) would normally require a more clear-cut justification in bankruptcy policy than is plausibly found in § 546(e), at least as applied to the Madoff facts. The applicability of the safe harbor in this context becomes even more questionable once we see that the transactions underlying

⁵⁷ See, e.g., *Picard v. HSBC Bank PLC*, 454 B.R. 25, 38 (S.D.N.Y. 2011) (deciding those issues against the trustee); *Picard v. HSBC Bank PLC*, 450 B.R. 406, 410 (S.D.N.Y. 2011) (stating that threshold issues involving “substantial and material interpretation of non-bankruptcy federal law” require withdrawal of bankruptcy reference).

⁵⁸ *Picard v. Katz*, 462 B.R. 447, 450 (S.D.N.Y. 2011).

⁵⁹ See Christopher W. Frost, *Settlement Payments and the Safe Harbor of Section 546(e)*, 28 BANKR. L. LETTER NO. 5, at 1 (May 2008); Christopher W. Frost, *The Continued Expansion of Section 546(e): Has the Safe Harbor Swallowed the Rule?*, 31 BANKR. L. LETTER NO. 10, at 1 (Oct. 2011).

⁶⁰ See, e.g., *In re Grafton Partners*, 321 B.R. 527, 539 (9th Cir. B.A.P. 2005) (“The few decisions that involve outright illegality or transparent manipulation reject § 546(e) protection.”).

⁶¹ *Picard v. Madoff (In re Bernard L. Madoff Inv. Sec. LLC)*, 458 B.R. 87, 88 (Bankr. S.D.N.Y. 2011).

the common-law claim of V2 v. V1 do not involve the kind of fraudulent or preferential transfer by the debtor that the trustee normally has the power to avoid and that § 546(e) was presumably intended to shelter. The Madoff trustee has styled his restitution claims in terms of fraudulent transfer because SIPA invites him to do so. Courts in non-SIPA Ponzi cases have adopted the same approach without statutory direction. But the awkward language by which SIPA directs the “recovery of transfers” draws our attention to the reality of the situation: that a trustee’s restitution claim on behalf of Ponzi net losers can be treated as a fraudulent conveyance claim in bankruptcy only because it is deemed to be one.

IV. HOW SIPA DESCRIBES THE RESTITUTION CLAIM

A SIPA trustee asserts a claim on behalf of the debtor’s customers (not on behalf of general creditors) to recover “customer property” from persons to whom it has been transferred by the debtor.⁶² “Customer property” recovered by the trustee is allocated ratably to customers in proportion to their “net equity” claims; it is *not* available to meet the claims of general creditors. The same section goes on to provide that the trustee’s action to recover customer property may be deemed to be an action to avoid a fraudulent transfer. Actually it is a collective restitution claim, asserted by the trustee on behalf of the owners of the property to be recovered.

The difference is not just a quarrel over definitions, because it involves a fundamental distinction in the property interests involved and the remedies being employed to protect them. The “avoidance” actions of chapter 5 of the Bankruptcy Code originate in judicial remedies, reinforced by statutes, designed to protect the assets available to general creditors and the proportionate distribution thereof. Bankruptcy authorizes a trustee to pursue these remedies as the creditors’ representative, but the collective procedure directed by statute does not alter the interests at stake. Thus the avoidance actions uniformly seek recovery of what was formerly the debtor’s property. Transfers that are preferential, fraudulent, or unperfected are made subject to avoidance, either because they diminish the assets available to general creditors or because they undermine the policy of ratable distribution. The effect of avoidance in each instance is to augment the bankruptcy estate for the benefit of general creditors in proportion to their claims.

An action to avoid a real fraudulent transfer has all these characteristics. An action by a trustee or receiver to recover Ponzi payouts for the benefit of net losers – even if we agree to call it “fraudulent transfer” – has none of them. The fraud that underlies a Ponzi recovery is not the traditional fraud (whether “actual” or “constructive”) by the debtor on his general creditors; it is the fraud in the transaction between Swindler and V2, the same fraud that gives V2 a claim in restitution to recover “his” property wherever he can find it. Swindler’s creditors are not prejudiced by Swindler’s transfer of V2’s money

⁶² See 15 U.S.C. § 78fff-2(c)(3) (2006).

to V1, because Swindler's creditors are not entitled to take V2's money in satisfaction of Swindler's debts.⁶³ When Swindler pays V2's money to V1, in other words, he is not transferring "an interest of the debtor in property," at least in any meaningful sense, because the money is V2's property. (Even the notion that Swindler is motivated by "actual intent to hinder, delay, or defraud" his creditors makes a relatively poor fit, because Swindler's actual intent, in all likelihood, is merely to satisfy V1.) Most importantly – and sufficient by itself to distinguish this action from every form of chapter 5 avoidance – the stolen property recovered from V1 does not augment the bankruptcy estate, because it is restored to its owner (V2). This critical distinction, as we shall see in a moment, is explicitly acknowledged in SIPA's version of the trustee's action to recover customer property.

Set beside the "primordial" conception of fraudulent transfer⁶⁴ – in which a debtor transfers his own property to put it beyond the reach of creditors, and the transfer is subsequently avoided for the benefit of those creditors – the payout from a Ponzi scheme does not even make a good analogy. Courts have agreed to treat it as if it did: they recognize a "Ponzi presumption" by which any payment from a Ponzi scheme is deemed to meet the requirements of § 548(a)(1)(A), choosing to overlook the ways in which it does not fit.⁶⁵ But this is only because courts have adopted "fraudulent transfer" as the round hole for the square peg of V2's restitution claim.

The language in which SIPA describes this form of recovery is highly significant, because it acknowledges that the trustee's action to recover customer property is not really an action to avoid a fraudulent transfer:

(3) Recovery of transfers

Whenever customer property is not sufficient to pay in full the claims [for customers' "net equity" and SIPC reimbursement], the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of title 11. Such recovered property shall be treated as customer property. For purposes of such recovery, the property so transferred shall be deemed to have been the property of the debtor and, if such transfer was made to a customer or

⁶³ See *Begier v. IRS*, 496 U.S. 53, 58 (1990) ("Of course, if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated.").

⁶⁴ See Kenneth C. Kettering, *Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission*, 19 AM. BANKR. INST. L. REV. 319, 321 (2011).

⁶⁵ The necessary accommodation is described and defended in Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 186-88 (1998).

for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding.⁶⁶

The concluding sentence about “shall be deemed” is hard to understand until we recognize that this is a statutory “let’s pretend.” The trustee may recover what was formerly customer property from another customer to whom it was transferred by the debtor, as if this subsequent transfer were preferential or fraudulent, although we recognize it was a transfer of a different kind: in particular, because the property transferred was not property of the debtor, and because the subsequent transferee – if a customer of the broker – might not be regarded as a creditor at state law. Yet the pretense only goes so far. Avoidance of a real fraudulent transfer augments the bankruptcy estate for the benefit of general creditors, but that is not what the trustee is supposed to be doing here. So SIPA’s statutory version of V2’s restitution claim (prosecuted by the trustee on V2’s behalf) necessarily specifies that “recovered property shall be treated as customer property.”

A trustee who recovers customer property for the benefit of customers, rather than debtor property for the benefit of creditors, is pursuing a restitution claim on behalf of customers – whatever we might agree to call it. When the customers are Ponzi victims, the practical reasons to assign this role to the SIPA trustee are very strong. To begin with, it is essential that the victims’ restitution claims be aggregated and prosecuted together. This is not just for the sake of an orderly distribution, avoiding wasteful competition and a race to the courthouse between individual claimants, though that is naturally part of the reason. Unlike general creditors, who could pursue individual claims against the debtor if bankruptcy did not stop them, fraud victims whose property is no longer traceable *have* no individual claims in restitution to recover the property they have lost. (They undoubtedly have tort claims, but such claims merely make them creditors of BLMIS, sharing ratably with general creditors. Restitution recognizes their ownership of recovered “customer property,” sharing ratably with other fraud victims.) When the property of multiple fraud victims has been combined untraceably in what is called a “commingled fund,” the law of restitution recognizes a claim to recover the fund as a whole (or any part of it), rather than the property of any individual victim. The recovery belongs to the victims jointly, in proportion to their losses:

§ 59. Tracing into or Through a Commingled Fund

. . . .

(4) If a fund contains the property of multiple restitution claimants (such as the victims of successive fraud by the recipient):

⁶⁶ 15 U.S.C. § 78fff-2(c)(3); *cf.* 11 U.S.C. §§ 749(a) (2006) (stockbroker liquidation); *id.* § 764(a) (commodities broker liquidation).

(a) Each claimant's interest in the fund and any product thereof is determined by the proportion that such claimant's contributions bear to the balance of the fund upon each contribution and withdrawal

(b) If the evidence does not permit the court to distinguish the interests of multiple restitution claimants by reference to actual transactions, such claimants recover ratably from the fund and any product thereof in proportion to their respective losses.⁶⁷

The rule of § 59(4) reflects the universal legal response to the problem of untraceable, commingled assets,⁶⁸ and it is not a coincidence that SIPA embodies the same basic approach.⁶⁹ Given the simplifying assumption, stated at the outset, that all funds of Madoff investors were combined in a single bank account, the case presents a textbook example of a commingled fund, and there is no practical way to assert the investors' restitution claims except to assert them together.⁷⁰

⁶⁷ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 59 (2011).

⁶⁸ Modern law on the commingling or "confusion" of goods is little changed from the hypothetical cases originally propounded by Roman jurists. If your sheep are placed in the same pen with Titius's goats, your sheep and his goats – because still distinguishable – do not become common property. See J. INST. 2.1.28; 2 JAMES SCHOUER, A TREATISE ON THE LAW OF PERSONAL PROPERTY § 43 (3d ed. 1896) ("[S]o long as one can identify his own chattels, and take them away, the ownership of articles need suffer no change because all happen to be lumped in one lot."). But if grain of different owners is deposited in the same warehouse, each becomes owner of a ratable portion of the combined mass. See, e.g., DIG. 6.1.5.1 (Ulpian, Ad Edictum 16); U.C.C. § 7-207(b) (2003); see also U.C.C. § 9-336(f)(2) & official cmt. 4, ex. 1 (2000) (explaining that where SP1 has a security interest in debtor's eggs, SP2 has a security interest in debtor's flour, and debtor combines eggs and flour to make cakes, SP1 and SP2 have security interests in the cakes proportional to the value of the eggs and the flour, respectively). Commingled money is treated the same way, the only difference being that money in a commingled fund becomes untraceable more quickly. See generally Austin W. Scott, *The Right to Follow Money Wrongfully Mingled with Other Money*, 27 HARV. L. REV. 125 (1913).

⁶⁹ SIPA permits an individual customer to trace and reclaim "customer name securities," which are securities registered in the name of that customer. See 15 U.S.C. §§ 78fff-2(c)(2), 78lll(3). No other form of tracing is permitted, because all property of customers other than "customer name securities" is treated as commingled "customer property" to be allocated between customers in proportion to their net equity claims. See *id.* §§ 78fff-2(c)(1)(B), 78lll(4).

⁷⁰ Once a Ponzi scheme finds its way into bankruptcy court, neither V2 nor a class of V2s will be allowed to pursue restitution from V1 in competition with the trustee. The automatic stay of 11 U.S.C. § 362(a) (2006) does not by its own terms bar such a claim, which is directed neither against the debtor nor against "property of the estate"; but a court might reasonably conclude that V2's separate action would interfere with the collective claims asserted by the trustee. In *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff)*, 443 B.R. 295 (Bankr. S.D.N.Y. 2011), the court found that actions by certain investors against Madoff distributees threatened the trustee's ability to recover from the same defendants. The court held that it was authorized

SIPA's provision for "recovery of transfers" authorizes the trustee to do precisely this, and it is what the Madoff trustee is in fact doing. The question is how to interpret the language by which Swindler's payout to V1 is deemed to be a fraudulent transfer. If the statute were the sole source of V2's right to recover his property from V1, we might conclude that SIPA expands the usual definition of fraudulent transfer to supply a remedy that would not otherwise exist. But once we recognize the claim of V2 against V1 in its common-law version, we see that SIPA is merely codifying a preexisting liability and the only practical means (a suit by the trustee as representative) to enforce it. Deeming the trustee's claim to be one to avoid a fraudulent transfer is a drafting device to make the claim serviceable in bankruptcy terms, avoiding any reference to a background law that has become unfamiliar.

In many Ponzi cases the distinction might not make a difference, because the "deeming" technique can be employed to yield the same outcomes as common-law restitution – or close enough that the difference might not be worth worrying about. But in the Madoff case it has already made a significant difference on at least two issues so far.

The first is the question of the limitations or "reach-back" period governing the trustee's claims against net winners. Ideally, perhaps, a SIPA trustee with the full powers of an equity receiver could assert the collective state-law restitution claims of net losers against net winners without pretending they were anything else.⁷¹ State-law restitution claims would be subject to varying periods of limitation, but a typical statute allows six years or more.⁷² But the "deeming" substitute normally comes very close, because it is undisputed that Bankruptcy Code § 544(b)(1) allows the trustee to avoid fraudulent transfers (real or deemed) at state law. Deeming the collective restitution claim to be a

to enjoin these separate actions by 11 U.S.C. § 105(a), extending the reach of § 362(a) as necessary to bar the threatened interference. *See id.* at 315-19.

⁷¹ The SIPA trustee was originally given "the same powers . . . as a trustee in bankruptcy and a trustee under chapter X of the Bankruptcy Act." Securities Investor Protection Act of 1970, Pub. L. No. 91-598, § 6(b)(1), 84 Stat. 1647 (codified at 15 U.S.C. § 78fff (2006)). In the latter capacity he acquired, "if authorized by the judge[,] . . . such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor." Bankruptcy Act of 1938, No. 696, ch. 575, § 187, 52 Stat. 892 (codified in scattered sections of 11 U.S.C.). The provision was understood to mean that "it was the Congressional purpose to arm the [SIPA] trustee with even greater powers than those of a trustee in bankruptcy," 3-2 COLLIER ON BANKRUPTCY ¶ 60.85[2] (14th ed. 1988), and some courts held explicitly that these expansive powers enabled the SIPA trustee "to recover from third parties for the benefit of the customer fund. . . . He is not limited to standing in the shoes of the debtor." *SEC v. Albert & Maguire Sec. Co.*, 560 F.2d 569, 574 (3d Cir. 1977). With the 1978 amendments to SIPA, the language indirectly conferring the powers of an equity receiver disappeared. The reason for the change, presumably, was that the trustee under chapter X of the 1898 Act was being largely superseded by the debtor in possession under chapter 11 of the new Bankruptcy Code.

⁷² *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 70 (2011).

question of state-law fraudulent transfer makes the reach-back period dependent on state law as well, besides implicating state-law rules for choice of law: four years or more under the Uniform Act, three years in two states, six years or more in New York.⁷³ But a problem arises if the trustee is barred from avoiding (via § 544(b)(1)) what is deemed to be fraudulent transfer at state law, being allowed to avoid only what is deemed to be a fraudulent transfer under § 548(a)(1)(A), because § 548(a)(1) authorizes a reach-back period of only two years. This is why the most significant controversy between Madoff's net losers and net winners comes back to the applicability of § 546(e), the safe harbor for "settlement payments."

If the conclusion that § 546(e) limits Ponzi recoveries in SIPA cases were compelled by the plain meaning of the statute, the fact that such a limitation derogates from established rights at common law would be irrelevant. So would the curious fact that it apparently creates different classes of Ponzi victims, depending on the narrative by which they have been defrauded. Distributions that purport to be made "in connection with a securities contract"⁷⁴ are potentially subject to the two-year reach-back period of § 548(a)(1), while victims of different schemes – imaginary postal-coupon arbitrage, for example, or Malaysian latex glove manufacture – can still seek restitution (via § 544(b)(1)) for six or more years of payouts.⁷⁵

The common law of restitution and unjust enrichment cannot resolve this problem of statutory interpretation directly, but it has something to contribute. This is because the common-law account of the rights of net losers against net winners makes the best and most truthful demonstration that Swindler's payment to V1 of V2's money is not what the law ordinarily calls a fraudulent transfer: that label is a procedural fiction. It follows that the trustee's suit to recover V2's money is not really an exercise of the avoidance powers specified by the Bankruptcy Code: that is another part of the procedural fiction. The fiction serves its purpose by giving bankruptcy courts a convenient way to deal with a claim that the bankruptcy laws do not directly address: a restitution claim asserted by a trustee or receiver on behalf of multiple V2s in suits

⁷³ See UNIF. FRAUDULENT TRANSFER ACT § 9, 7A U.L.A. 194 (2006); N.Y. C.P.L.R. § 213 (MCKINNEY 2003). Arkansas and Mississippi have adopted nonuniform versions of the UFTA in which the basic limitation period is reduced to three years. Kettering, *supra* note 64, at 334 n.61. The uncertainty surrounding choice of law in fraudulent-transfer cases is the principal subject of the Kettering article.

⁷⁴ 11 U.S.C. § 546(e) (2006); *see also id.* § 741(7) (defining the term "securities contract").

⁷⁵ See *Cunningham v. Brown*, 265 U.S. 1, 7 (1924) (recounting Charles Ponzi's purported trading in postal coupons); *Donell v. Kowell*, 533 F.3d 762, 767 (9th Cir. 2008) (describing a fictitious scheme for an investment in Malaysian latex glove manufacture). The scope of the statutory shelter for "settlement payments" in connection with "securities contracts" is potentially broad enough to reach many Ponzi schemes with a financial flavor – perhaps including these examples. But the scope of fraud is broader still.

against multiple V1s. Such a claim is rock-solid at common law. Absent “deeming,” it has no particular connection to bankruptcy.

If the argument over § 546(e) concedes any relevance to legislative intent, it starts from the premise that Congress acted “to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries.”⁷⁶ The wholesale avoidance of late-stage “settlement payments” by a commodities or securities broker, on the ground that they were preferential or (constructively) fraudulent by normal bankruptcy standards, might well threaten the sort of instability with which Congress was apparently concerned. But it is difficult to see that common-law restitution claims between Ponzi victims *inter se*, considered in the aftermath of the scheme, carry any implications at all for the stability of financial markets. (It is especially difficult if the essence of the fraud was that real-life financial markets were not actually involved.) The fact that the victims’ claims are substantial, and that they are adjudicated in a quasi-bankruptcy setting, does not make the Madoff liquidation “a major bankruptcy affecting those industries.” (If the defining concern of bankruptcy is with “the restructuring of debtor-creditor relations,”⁷⁷ the rights of net losers against net winners are not bankruptcy at all.) Whatever the purpose of § 546(e), it was presumably intended to limit real bankruptcy avoidance actions, not restitution claims between fraud victims that might be asserted outside bankruptcy altogether.

Proper characterization of the net losers’ claims is equally important to a lesser controversy, concerning the Seventh Amendment right to a jury trial. The court ruled in *Picard v. Katz* that the Madoff trustee was constitutionally entitled to a jury trial of his claims on behalf of net losers against net winners; indeed, the case was settled on the day jury selection was scheduled to begin.⁷⁸ The ruling relied on the Supreme Court’s 1989 decision in *Granfinanciera v. Nordberg*,⁷⁹ in which Justice Brennan – after reviewing the historical practice of English law and equity – concluded that an eighteenth-century assignee in bankruptcy “would have had to bring his action to recover an alleged fraudulent conveyance of a determinate sum of money at law . . . and that a court of equity would not have adjudicated it.”⁸⁰

There can be little doubt that fraudulent conveyance actions by bankruptcy trustees . . . are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors’ hierarchically ordered claims to a pro rata share of the bankruptcy res.⁸¹

⁷⁶ *Picard v. Katz*, 426 B.R. 447, 452 (S.D.N.Y. 2011) (quoting *In re Manhattan Inv. Fund Ltd.*, 310 B.R. 500, 513 (Bankr. S.D.N.Y. 2002)).

⁷⁷ *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982).

⁷⁸ *Picard v. Katz*, 55 Bankr. Ct. Dec. 200 (S.D.N.Y. 2011); see also *supra* note 3.

⁷⁹ 492 U.S. 33, 46-47 (1989).

⁸⁰ *Id.* at 46-47.

⁸¹ *Id.* at 56.

These conclusions are open to serious question as legal history.⁸² Taking them at face value, however, the Court in *Granfinanciera* was at least referring to a genuine fraudulent conveyance: a transaction, like the one before the Court in 1989, that might actually have been regarded as a “fraudulent conveyance” in the eighteenth century. By contrast, the Madoff trustee was demanding a jury trial of a restitution claim between fraud victims – a claim that has only been assimilated to a fraudulent conveyance action in order to find a home for it in the modern bankruptcy statutes.

Seen instead for what it is, V2’s restitution claim against V1 bears all the earmarks of equity rather than law. V2 does not seek to collect damages or enforce a debt, but to retake property of which he was deprived by the fraud of a third person. Such a claim asserts V2’s equitable ownership of property to which V1 has obtained legal title. It requires V2 to trace his property through changes in form (here a commingled fund) into the hands of V1, and it implicitly seeks to revest title to the traceable proceeds by an equitable remedy such as constructive trust or equitable lien. Determining the amount for which V1 may be liable (investments minus withdrawals) requires supplemental calculations in the nature of an equitable accounting, and V1’s defenses (bona fide payee, change of position) are equitable as well. These features of the case do not amount to a rigorous demonstration that the “hierarchical ordering” of claims between eighteenth-century Ponzi victims would have taken place in Chancery, though they surely make it likely. But unless we recognize what the Madoff trustee is actually doing when he sues to recover payouts to net winners for the benefit of net losers, a proper Seventh Amendment inquiry cannot even begin.

V. THE BACKGROUND RECEDES

SIPA invites trustees and judges to treat an action for restitution of “customer property” as if it were a fraudulent transfer, but calling something a fraudulent transfer does not make it one. Understanding how the rights of Ponzi victims *inter se* would be characterized and enforced in the absence of statute is essential to interpreting SIPA’s language about “recovery of transfers.” The statute codifies a collective, common-law restitution claim and gives it a bankruptcy label for convenience. The question is whether attaching the label alters the underlying nature of the claim: who is trying to recover what from whom, and on what legal basis.

That question has urgent practical implications. If the SIPA trustee’s claim to restitution from net winners is necessarily regarded – for all purposes – as an action to avoid a fraudulent transfer, it is certainly possible that Bankruptcy Code § 546(e) shortens the reach-back period that would otherwise be applicable in the Madoff case from six years to two. It is even conceivable that historically equitable claims and remedies have been transformed by SIPA into

⁸² See generally John C. McCoid, *Right to Jury Trial in Bankruptcy: Granfinanciera, S.A. v. Nordberg*, 65 AM. BANKR. L.J. 15 (1991).

“quintessential” actions at law. Neither consequence is possible unless SIPA, by its resort to “deeming,” is understood to have displaced a preexisting common-law-and-equity claim and substituted a claim of a different kind.

The likelihood that a statutory overlay will ultimately obscure a common-law background depends on how vividly the background is perceived. As it happens, restitution claims in bankruptcy invoke some of the most faded landscapes of the common law: equitable interests in property and the equitable remedies by which they are protected. Controversies over restitution in bankruptcy over the last two decades all involve the same inability (or unwillingness) to recognize equitable rights and remedies that were commonplace until fairly recently. The claim of V2 to recover his property from V1, as illustrated by the Madoff liquidation, is squarely in this category. So is the claim of the fraud victim to retake (from the bankruptcy trustee) identifiable property lost by the victim to the fraud of the debtor. (An elementary restitution claim of this kind is what led the court in *Omegas Group* to announce that “Constructive trusts are anathema to the equities of bankruptcy.”⁸³) So too is the claim of the fraud victim to retake his identifiable property ahead of less fortunate fellow victims whose property has been untraceably commingled. (This is the claim that has recently led numerous courts to declare that the owner’s right to “trace” stolen property is a matter of equitable discretion.⁸⁴)

Equitable property interests in each of these settings were once as familiar to lawyers as any other part of the decisional law, and their present obscurity is surely one of the great unanticipated consequences of American legal history. Procedural reforms culminating in the adoption of the Federal Rules of Civil Procedure in 1938 prescribed one form of civil action, but they did not abolish the distinction between law and equity, let alone eliminate equitable rights and remedies. The reformers cannot have foreseen – and it is difficult even now to reconstruct – the gradual process by which the elimination of a separate equity jurisdiction would lead first to the disappearance of equity from the law school curriculum, then to an ebb tide in professional awareness, as lawyers who had never learned these rules gradually took over from those who had.

Neither SIPA nor the Bankruptcy Code is concerned with claims between fraud victims *inter se* in the aftermath of a Ponzi scheme. Claims of this sort are directly identified, explained, and regulated by the background common-law-and-equity of restitution and unjust enrichment. Statutes that do not address these claims cannot have been intended to displace them, and they cannot have that effect unless – by losing sight of the background – we come to regard a procedural overlay as the exclusive source of applicable law. Professional myopia on this pattern will sometimes have significant practical consequences. In the Madoff case, the restitution claims of net losers against

⁸³ *XL/Datacomp, Inc. v. Wilson (In re Omegas Grp., Inc.)*, 16 F.3d 1443, 1452 (6th Cir. 1992).

⁸⁴ See sources cited *supra* note 50.

net winners have been made subject to an extraneous statute of limitations and recharacterized as legal rather than equitable. In every case, losing sight of the common-law dimension diminishes the substance and coherence of our available legal materials, making it that much harder to understand what we are doing and why.