Black Swans, Ostriches, and Ponzi Schemes

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ARTICLE

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What did he know, and when did he know it?

—Howard Baker (referring to Richard Nixon during Watergate)[1]

A few months ago, two different federal district court judges in the Southern District of New York went two different ways on the issue of whether the Madoff investors ran the risk of having to disgorge both their "on the book" profits—much of which would be fictional profits only—and the principal that they invested with Madoff.[2] In *Picard v. Merkin (In re Bernard L. Madoff Investment Securities, LLC)*, the district court ruled that the complaint filed by Madoff trustee Irving Picard, which alleges fraudulent transfers based on both actual and constructive fraud, could survive a motion to dismiss.[3] Judge Wood held that, when it comes to fraudulent transfers under both the Bankruptcy Code and New

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1 *See Howard Baker*, WIKIPEDIA, http://en.wikipedia.org/wiki/Howard_Baker (last visited Dec. 18, 2011).

2 A third recent case, *Picard v. JPMorgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2011), also weighed in on this issue, ultimately ruling that the trustee didn't have standing to pursue all of the claims. In the one paragraph of the opinion that I liked, the court referred to the Trustee as working "relentlessly." *Id.* at 88.

3 Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec., LLC), No. 11 MC 0012(KMW), 2011 WL 3897970 (S.D.N.Y. Aug. 31, 2011).

York state law, it's the intent of the debtor-transferor that matters, not the intent of the transferee.[4] She also held that the section 546(e) safe harbor defense[5] wasn't a "get out of court free" card (my words, not hers) at this stage of the proceeding, either, because the bankruptcy court had not yet determined whether the safe harbor applied.

Less than a month later, in *Picard v. Katz*,[6] the district court dismissed all of Picard's claims except the actual fraud and equitable subordination claims, in part by finding that Madoff's firm "was a registered securities brokerage firm, a fact that directly invokes certain 'safe harbor' provisions of the Bankruptcy Code . . . ."[7] Judge Rakoff decided as a matter of law that section 546(e) had kicked in, thereby eliminating Picard's preference and constructive fraud claims. He further held that the investors' principal was safe from recovery absent any actual bad faith by an investor, but that the fictional profits might be recovered:[8]

> [W]hile as to payments received by the defendants from Madoff Securities equal to a return of their principal[,] defendants can defeat the Trustee's claim of actual fraud simply by proving their good faith, as to payments received by the defendants in excess of their principal[,] defendants can defeat the Trustee's claim of actual fraud only by showing that they not only were proceeding in good faith but also that they took for value.

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[4] *Id.* at *8-11. She pointed out, though, that under New York law, the issue of the transferee's intent gets more complicated. The transferee's intent comes into play, but just as an affirmative defense (or if the plaintiff is seeking attorney fees). *Id.* at *12-13. The tricky thing when using state law to avoid a transfer under section 544 is that state laws (by their very nature) aren't uniform. For fraudulent transfers, those state laws may be based on the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act, but they may not follow UFTA/UFCA exactly.

[5] Section 546(e) provides:

> Notwithstanding sections . . . 547, 548 (a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, . . . commodity contract, . . . or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C.A. § 546(e) (Westlaw 2012).

[6] Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011).

[7] *Id.* at 451.

[8] *Id.* at 454 (footnote omitted).

The court then explained that mere inquiry notice that there *might* have been fraud wouldn't be sufficient,[9] but willful blindness to the fraud would "constitute a lack of good faith."[10] In essence, if reasonable people confronted with the Madoff scheme might have been inclined to say, "what the hey?," that wouldn't matter. Only the most deliberate type of ignorance—the legal equivalent of plugging one's ears while humming tunes—would demonstrate a lack of good faith.[11]

So, depending on which court is correct, the Madoff investors either have several hoops to go through to establish a defense or very few hoops. The applicability of the safe harbor defense is either a question of fact or a question of law. If Judge Wood is correct, and the safe harbor defense is a question of fact, then investing in a deal that seemed too good to be true carries significant risks. If Judge Rakoff is correct, and the safe harbor defense kicks in when a business holds[12] a broker's license to buy and sell stock,[13] then investors aren't obliged to check out the bona fides of too-good-to-be-true deals unless those deals are so obviously fraudulent that no one could ever mistake them for legitimate deals. (Under Judge Rakoff's theory, I envision the fraudulent deals as carrying legends saying, "Warning! I am not a real deal. Invest at your peril.")

To me, the issue involves that very Howard Baker-ish inquiry of what the investors knew and when they knew it. In order to resolve that issue, we have to ask ourselves what clues there were to the Ponzi scheme that Madoff ran. And to do *that*, we must examine what we know—or think we know—about investing, period. More importantly, we must examine when and how we should question our assumptions about investing.

> Before the discovery of Australia, people in the Old World were convinced that all swans were white, an unassailable belief as it seemed completely confirmed by empirical evidence. The sighting of the first black swan might have been an interesting surprise for a few ornithologists (and others extremely concerned with the coloring of

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[9] *Id.* at 455.

[10] *Id.* at 454 (footnote omitted). I have to admit that I was a bit surprised by the court's rhetorical question: "But why would defendants willfully blind themselves to the fact that they had invested in a fraudulent enterprise?" *Id.* There are a *lot* of reasons why the defendants might have done just that, as this essay discusses.

[11] The Madoff trustee has appealed Judge Rakoff's ruling.

[12] ". . . Madoff Securities was a registered securities brokerage firm, a fact that directly invokes certain 'safe harbor' provisions of the Bankruptcy Code . . . ." *Id.* at 451.

[13] The fact that Madoff may not have actually been buying securities didn't seem to bother the court.

> birds), but that is not where the significance of the story lies. It illustrates a severe limitation to our learning from observations or experience and the fragility of our knowledge. One single observation can invalidate a general statement derived from millennia of confirmatory sightings of millions of white swans. All you need is one single (and, I am told, quite ugly) black bird.
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> —Nassim Taleb, *The Black Swan: The Impact of the Highly Improbable*[14]

On long drives, I like to listen to books on CD, and I've been listening to Malcolm Gladwell's book *What the Dog Saw and Other Adventures*.[15] In the chapter *Blowing Up: How Nassim Taleb Turned the Inevitability of Disaster Into An Investment Strategy*,[16] Gladwell describes Nassim Taleb's approach to investing. The gist of the chapter is that Taleb believes that he can't figure out the market (nor can anyone else), and so, instead, he's developed a system of managing risks without buying into the fallacy that he can somehow beat the system through sheer brainpower.

> Empirica [Taleb's company] follows a very particular investment strategy. It trades options, which is to say that it deals not in stocks and bonds but with bets on stocks and bonds . . . .
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> . . . .
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> Taleb . . . has constructed a trading philosophy predicated entirely on the existence of black swans, on the possibility of some random, unexpected event sweeping the markets. He never sells options, then. He only buys them . . . . [H]e buys options on both sides, on the possibility of the market moving both up and down.[17]

Countless gurus (and Madoff was one of them, albeit a fake one) contend that they can beat the system—that, based on their own analysis, they can determine how to make scads of money due to their choice of which stocks to buy, sell, or hold.[18] The problem is that they confuse correlation with causation. (Or, in Madoff's case, the problem was that

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[14] NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE xvii (2007) [hereinafter TALEB].

[15] MALCOLM GLADWELL, WHAT THE DOG SAW: AND OTHER ADVENTURES (2009).

[16] *Id.* at 51.

[17] *Id.* at 58.

[18] My husband swears by Jim Cramer's approach: doing some serious homework before and after investing in a company. (When we watch Cramer's show, though, I don't swear by him; I swear *at* him. And what on earth does "booyah!" mean?)

he was flat-out lying.) The gurus assume that their stock market profits are caused by their understanding of how a particular company runs its business. Balderdash. They buy and sell; some of their investments work out and some don't. The analysis may correlate with their profits, but it doesn't cause them.

Just because a person has managed to make some money on a particular stock at a particular time doesn't mean that he has figured out a way to beat the stock market.[19] What counts is his willingness to look for counter-factual evidence as a way of cross-checking his assumptions.[20] He needs to look for "black swans." "Black swans" are events that involve three components: (1) they are wildly unusual events (2) with big ramifications (3) that we rationalize as "normal" after the fact.[21] One such black swan is the investment that never, ever shows a loss. That particular black swan is a signal to abandon ship (as Jim Cramer puts it, "sell, sell, sell") and run hard in the other direction.

That's why I have less sympathy than might be seemly for the people who invested with Bernie Madoff.[22] I feel horrible that many of them lost their life savings. I feel bad for them as fellow human beings. But I wonder why so many smart people ignored the red flags that signal a fraud. With many schemes to disguise the financial statements of underperforming (or fictional) businesses, there were red flags, but people choose not to see them. They miss the black swans. In fact, they became ostriches by burying their heads in the sand.[23]

Irving Picard sees ostriches in the Madoff story, too:

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[19] For years, we were "Baby Berkshire" shareholders because we liked Warren Buffett's investment philosophy. We still like Mr. Buffett as a person, but we sold the stock when the returns lagged the market for several quarters.

[20] Of course, it makes sense to pay attention to things like how a company behaves, especially after some big-name companies like Enron, Tyco, and WorldCom have imploded in very public ways. For many of us, our confidence in companies' financial statements were shaken when we read news story after news story on the type of financial engineering that misled investors. Paying attention to obvious clues is important—who wants to invest in a company that's poorly run or downright rotten?

[21] TALEB, at xvii-xviii.

[22] I'm not alone. Check out Jack Ayer's analysis of whether the Madoff investors actually did lose "everything." *See Bernie's Investors: Did They Lose "Everything?"*, UNDERBELLY BLOG (Dec. 15, 2008, 1:06 PM), http://underbelly-bucc.blogspot.com/2008/12/bernies-investors-did-they-lose.html.

[23] OK, ostriches don't really bury their heads in the sand. *See* AMERICAN OSTRICH ASSOCIATION, www.ostriches.org/factor.html#head (last visited Dec. 18, 2011). But from a distance, apparently, it can look as if they do. For the best opinion using pictures of an ostrich and a human, both burying their heads in the sand, see *Gonzalez-Servin v. Ford Motor Co.*, No. 11-1665, 2011 WL 5924441 (7th Cir. Nov. 23, 2011), *available at* www.abajournal.com/files/DG0R2WE8.pdf. OK, it's the *only* such opinion, but it's a marvelous opinion just the same.

> The Sterling Partners knew or should have known that Madoff's fund was too good to be true because it consistently yielded positive gains coupled with ultra low volatility. Between 1998 and 2008—a period during which the S&P 100 produced negative returns for nearly 60 months—Sterling's KW BLMIS Accounts rarely reported negative monthly rates of return. During that same ten-year period, of the 483 KW BLMIS Accounts administered by Sterling, none purportedly experienced more than five down months, and many purportedly never had a single down month.
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> . . . .
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> The disconnect between Madoff's returns and the equity market was particularly obvious during periods of market dislocation, which should have caused the Sterling Partners to question Madoff's prophetic market timing. Remarkably, Sterling's BLMIS investments were effectively immune from any number of market catastrophes, enjoying steady rates of return at times when the rest of the market was experiencing financial crises.[24]

In the *Sterling* litigation, as in the *Katz* and *Merkin* litigation, Picard seeks to recover certain transfers under sections 544(b), 547, 548, and 550(a) of the Bankruptcy Code and under state law.[25] His attempt to get the Madoff investors to pay back into the estate any fictional profits that they earned, with some clawback periods going as far back as six years,[26] is the right approach.[27] I'm not the only one saying that: the Second Circuit did, too.[28] As between those creditors who had the tools to figure

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[24] Complaint at 193-95, Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec., LLC), Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Dec. 7, 2010), *available at* http://graphics8.nytimes.com/packages/pdf/0204sterlingcompaintfinal.PDF [hereinafter Sterling Complaint] (on file with the Golden Gate University Law Review).

[25] *Id.* at 205-364.

[26] The Sterling Complaint uses reachback periods of ninety days for some counts (the preference counts), two years for others (the federal fraudulent transfer counts), and six years for still others (the state law fraudulent transfer counts). *See id.* at iii-iv.

[27] His theory is called the net-investment approach. Bob Van Voris & Linda Sandler, *Madoff Trustee Picard Wins Ruling on Calculating Losses*, BUSINESSWEEK, Aug. 16, 2011, *available at* www.businessweek.com/news/2011-08-16/madoff-trustee-picard-wins-ruling-on-calculating-losses.html ("The federal appeals court in New York said today that trustee Irving Picard can calculate losses by subtracting the amount withdrawn from an investor's account from the total placed with Madoff, the so-called net investment method.").

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> In satisfying customer claims in this case, Mr. Picard, as the SIPA Trustee, determined that the claimants are customers with claims for securities within the meaning of SIPA. The Trustee further concluded that each customer's "net equity" should be calculated by the "Net Investment Method," crediting the amount of cash deposited by the customer into his or her BLMIS account, less any amounts withdrawn from it.

out that something fishy was going on and any other types of creditors without those tools (for example, any tort creditors), my vote goes to the creditors who had zero chance to bail out in time. There are valid reasons to penalize investors who chose to stick with investments that were too good to be true.

I. RED FLAGS AND BLACK SWANS—AND OSTRICHES

> While bad business strategy and bad investment decisions can and do contribute to a company's fall, it is a company's desperate attempt to use accounting tricks to hide bad decisions that often seals its fate.
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> —Bala G. Dharan, *Enron's Accounting Issues: What Can We Learn to Prevent Future Enrons?*[29]

Hearken back to the first wave of accounting scandals in this century: the Enrons and WorldComs and their ilk. Although an investor would have to have been paying close attention to the financial statements that these companies produced,[30] a savvy investor might have seen some patterns. At some point after Rich Kinder left Enron, all sorts of financial indicators started to go haywire. For example, there weren't any blips in Enron's cash flow from earnings:

> One of the most common measures of earnings quality used by financial analysts, debt-rating agencies, and accounting academics is

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In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 233 (2d Cir. 2011); *see also* Elizabeth Amon, *Madoff Trustee Sets $272 Million Payout, Sept. 15 Record Date*, BLOOMBERG (Sept. 12, 2011, 3:36 AM), *available at* www.bloomberg.com/news/2011-09-12/jpmorgan-chase-bofa-kkr-madoff-dow-ford-in-court-news.html.

[29] Bala G. Dharan, *Enron's Accounting Issues: What Can We Learn to Prevent Future Enrons?*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 113, 115 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

[30]

> Enron's loss of investor faith started with the company's 2001 third quarter earnings release on October 16, 2001. As earnings releases go, this one must rank as one of the most misleading. The news release said, in an underlined and capitalized headline, "Enron Reports Recurring Third Quarter Earnings of $0.43 per diluted shares." The headline went on to reaffirm "recurring earnings" for the following year, 2002, of $2.15 per share, a projected increase of 19% from 2001. But an investor had to dig deep into the news release to know that Enron actually lost $618 million that quarter, for a loss of ($0.84) per share. A net loss of $618 million loss was converted to a "recurring net income" of $393 million by conveniently labeling and excluding $1.01 billion of expenses and losses as "non-recurring."

Id.

> the so-called accruals, which is the difference between net income and cash flow from operations ("CFO"). Accruals are positive when net income is greater than CFO. When this happens, it usually indicates poor earnings quality issues. Interestingly, Enron was apparently very aware of the importance of CFO for analysts and bond rating agencies. In fact, *Enron ensured by whatever means necessary that the annual reported CFO always exceeded the net income* . . . .[31]

To make matters worse, Enron omitted some important information that should have put the stock analysts (and Enron shareholders) on high alert.

> Enron's 2001 third quarter earnings press release, on October 16, 2001, contained another major shortcoming—lack of information about its balance sheet and cash flows. While the company's press release provided information on net income, the company failed to provide a balance sheet. This is inexplicable—we teach in Accounting 101 that the income statement and the balance sheet are interrelated ("articulated") statements. This essentially means that we cannot really prepare one without preparing the other. Not surprisingly, almost every major company's earnings release contains the balance sheet along with its income statement. Financially responsible companies would also provide a cash flow statement. Analysts and investors puzzled with Enron's lack of balance sheet disclosure had to wait until after the markets closed on October 16, 2001, when the senior management disclosed—in response to a question during the earnings conference call—that it had taken a $1.2 billion charge against its shareholders' equity (a balance sheet item), including what was described as a $1 billion correction of an accounting error.[32]

One billion dollars is a heck of an "oops," and investors and analysts who read about this particular "oops" should have dug deeper into how the "error" occurred.[33] I know that accounting is an art, not a science,[34]

[31] Bala G. Dharan & William R. Bufkins, *Red Flags in Enron's Reporting of Revenues and Key Financial Measures*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 97, 109 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (emphasis added); *see also id.* at 110 ("As the data illustrate for the year 2000, Enron reserved almost all of its financial management of cash flow data to the fourth quarter. Similar troubling contrasts in the behavior of Enron's cash flow from operations for Quarters 1-3 and Quarter 4 existed for previous years as well, including 1998 and 1999.").

[32] Dharan, *Enron's Accounting Issues: What Can We Learn to Prevent Future Enrons?*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS at 116.

[33] Jim Chanos dug deeper into Enron, and he didn't like what he dug up.

> Given that Enron's net income margins had also declined from over 4% of revenue to less than 1%, the negative free cash flows should have been a major red flag for any

and high-magnitude errors do occur. But when they do, it's important to make sure that the errors are, well, really errors, rather than lies.

I don't expect normal people[35] to go around scrutinizing company financial statements looking for accounting signals of possible misrepresentation. And part of Enron's collapse was due to the failure of many analysts (and rating agencies)[36] to question Enron and to publicize

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> analyst trying to value Enron's equity. It certainly caught the attention of hedge fund manager Jim Chanos of Kynikos. He was quoted as saying, "No one could explain how Enron actually made money . . . . Not only was Enron surprisingly unprofitable, but its cash flow from operations seemed to bear little resemblance to reported earnings."

Dharan & Bufkins, *Red Flags in Enron's Reporting of Revenues and Key Financial Measures*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS at 111 (quoting Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58) (footnotes omitted); *see also* Andrew Hill, *Enron: Virtual Company, Virtual Profits*, FT.COM (Feb. 3, 2002), *available at* http://specials.ft.com/enron/FT3648VA9XC.html ("Enron bolstered profits by booking income immediately on contracts that would take up to 10 years to complete. It shifted debts into partnerships it created and in effect controlled, even though defined by auditors as off balance sheet. It used such entities to manipulate its accounts at the end of each quarter and employed financial derivatives and other complex transactions aggressively to the same end. It masked poorly performing assets with rapid deal-making."). In fact, at some point, we were probably all on notice that financial statements might not be as accurate as they had seemed. *See supra* text accompanying note 20.

34 *See, e.g.*, Matthew J. Barrett, *Enron and Andersen—What Went Wrong and Why Similar Audit Failures Could Happen Again*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS at 158 ("Accounting remains an art, not a science, which requires enterprises, and their auditors, to exercise professional judgment in preparing and auditing financial statements.").

35 Not that accountants are abnormal. They're not any more abnormal than lawyers—not that that's saying much.

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> Moreover, a thorough inquiry into these dealings also should include the major financial market "gatekeepers" involved with Enron: accounting firms, banks, law firms, and credit rating agencies. Employees of these firms are likely to have knowledge of these transactions.
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> With respect to Enron, all of these gatekeepers have questions to answer about the money they received, the quality of their work, and the extent of their conflicts of interest. . . .
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> Finally, and perhaps most importantly, the three major credit rating agencies—Moody's, Standard & Poor's, and Fitch/IBCA—received substantial, but as yet undisclosed, fees from Enron. Yet just weeks prior to Enron's bankruptcy filing—after most of the negative news was out and Enron's stock was trading at just $3 per share—all three agencies still gave investment grade ratings to Enron's debt. The credit rating agencies in particular have benefitted greatly from a web of legal rules that essentially requires securities issuers to obtain ratings from them (and them only), and at the same time protects those agencies from outside competition and liability under the securities law. They are at least partially to blame for the Enron mess.

Frank Partnoy, *Enron and the Derivatives World*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS at 177-78.

their misgivings. Most analysts didn't do enough parsing of Enron's financial statements. But some did.[37]

The key for those of us with little to no accounting background isn't to learn accounting principles. It's to read news stories and ask questions. It's to be skeptical when things look too good to be true. When a magazine like *Fortune* runs stories like *Is Enron Overpriced?*,[38] that information is available and accessible to all of us. Our choice to ignore accessible information makes us ostriches.[39] And voluntarily becoming an ostrich—a know-nothing—must have consequences.

II. "HAVES" AND "HAVE NOTS" IN TERMS OF SECOND CHANCES

In bankruptcy, we often have the "haves" (e.g., fully secured creditors with collateral that goes up in value over time)[40] and the "have nots" (e.g., unsecured creditors in a bankruptcy in which the estate runs out of money before paying anything to the unsecureds). Even among unsecured creditors, we can also have "haves" and "have nots." The classic "haves" are those unsecured creditors with priority claims that must be paid in full before claims lower down the pecking order get anything.[41]

But there's another way of thinking about this "haves" / "have nots" distinction: on the one hand, there are those unsecured creditors who saw the light at the end of the tunnel, realized that the light was actually an oncoming train,[42] and had a chance to get out of the way before the train hit them; and, on the other hand, there are those who were flattened by the train before they could even see it coming. Those Madoff investors who saw their wildly implausible positive returns were among those who

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[37] Jim Chanos and Bethany McLean come to mind. And in the Madoff scandal, so does Harry Markopolos, who tried to alert the SEC to Madoff's shenanigans. *See, e.g.*, Allan Chernoff, *Madoff Whistleblower Blasts SEC*, CNN MONEY, Feb. 24, 2009, *available at* http://money.cnn.com/2009/02/04/news/newsmakers/madoff_whistleblower/.

[38] Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, *available at* http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/index.htm.

[39] My dad, who is a chemist, said that the most difficult part of any experiment is to analyze the parts that go "right," and to ask yourself if they went "right" because they were right, or because of luck or another factor.

[40] Unlike our home's value. Now *that* was a black swan that swam over, bit us hard, hit us with its wings, and then jumped up and down on our backs before it flew off, chuckling to itself.

[41] For the distribution scheme in bankruptcy, see 11 U.S.C.A. § 507 (Westlaw 2012).

[42] "The light at the end of the tunnel is just the light of an oncoming train." *Robert Lowell Quotes*, GOODREADS, www.goodreads.com/author/quotes/36912.Robert_Lowell (last visited Dec. 18, 2011).

"had" a chance to escape before the Ponzi scheme escalated.[43] They just didn't take it.

Few real investments only appreciate in value.[44] My husband and I have a few. Our joint savings account, with its measly interest rate, is one. Our CDs and T-bills are others. All of these types of investments, though, are exceptionally low-risk, and their low returns reflect that low risk.

But I can't think of a single investment based on the stock market that *always* makes a profit. And the[45] reason that I can't think of one is that I know that, in every good investment, profits ebb and flow. I don't expect every quarterly return to show steady growth, especially not in the double-digits. I know that an all-growth, all-the-time return isn't even a black swan. It's a plaid one.[46]

So the very wealthy people[47] who begged and pleaded with Bernie Madoff to handle their investments, who gave him their money in exchange for the faux double-digit returns on their investments, and who bought into the idea that Madoff "knew" the market, should have known that something was peculiar. Those very wealthy people had access to all sorts of other advisors who could have questioned the Madoff investment strategy. Those selfsame very wealthy people could have used their leverage to ask Madoff for more information. They had a chance to get out of the train tunnel. They didn't.[48]

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[43] The trick, as my buddy Jessica Gabel has pointed out, is in figuring out where to draw the line between the "had-a-chance-to-get-outs" and the "never-could-have-had-a-clue" folks. Those are subjective decisions, and based on how things are going right now in the Southern District of New York, those decisions may well depend on which judge draws the case.

[44] *Cf. supra* notes 40 and 42.

[45] Other reasons might include a lack of knowledge or a failure of imagination, but I'm not going to explore either of those two in this Article.

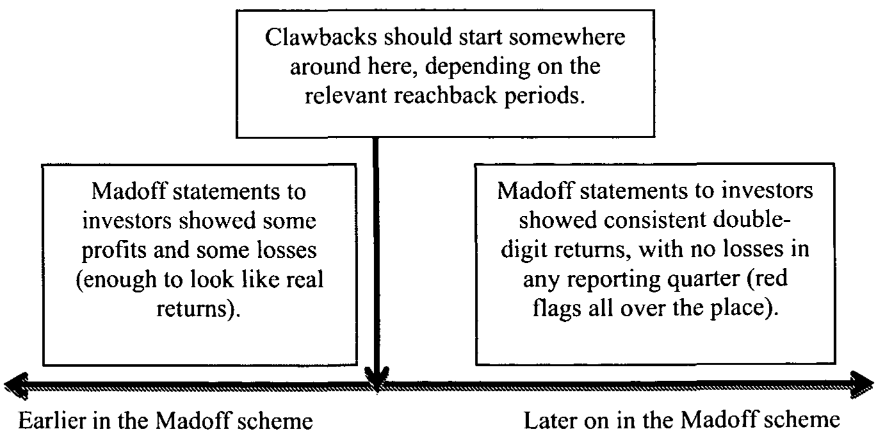
[46] I'm reasonably certain that no plaid swans exist, except perhaps in law school hypotheticals.

[47] During Madoff's sentencing, there were several references to middle-class investors who had been harmed by his actions. *See, e.g.*, Benjamin Weiser, *Judge Explains 150-Year Sentence for Madoff*, N.Y. TIMES, June 28, 2011, *available at* www.nytimes.com/2011/06/29/nyregion/judge-denny-chin-recounts-his-thoughts-in-bernard-madoff-sentencing.html?pagewanted=all; Diana B. Henriques, *Madoff is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, June 29, 2009, *available at* www.nytimes.com/2009/06/30/business/30madoff.html?scp=1&sq=madoff%20sentencing&st=cse; Tomoeh Murakami Tse, *Madoff Sentenced to 150 Years*, WASH. POST, June 30, 2009, www.washingtonpost.com/wp-dyn/content/article/2009/06/29/AR2009062902015.html. I'm not as sure that middle-class investors had easy access to the types of advisors who could have warned their clients about Madoff's red flags, but, based on seeing the type of research that my husband does before investing, it's possible that people other than the very wealthy could have figured out the warning signs, too.

[48] It breaks my heart that Elie Wiesel's foundation was one of the investors.

And because they didn't get out of the train tunnel, their faux profits shouldn't be honored. Irving Picard is correct when he insists that faux profits shouldn't be part of the investors' claims.[49] He's also correct—and fair—when he suggests that, instead, the investors' legitimate claims are limited to only the dollar amounts that they paid into Madoff's fund.[50] Any other approach would give the Madoff investors two rewards: their faux profits, and a jump over those unsecured creditors who had no way of discovering that something funny was going on.

What about those Madoff investors who invested near the beginning, before the Ponzi scheme began? Should they get their profits back on the theory that those profits actually were real? That's a tough call that, to me, hinges on whether any of their Madoff returns showed some losses. Fraud that's disguised, such as fraud that depicts realistic profits and losses (even if those figures are lies), is very different from fraud that's out in the open. If those early investors made real money, and the statements that they received from Madoff looked like real (read: normal) investments, they should be able to keep those profits. The line between investors who should keep their profits and investors who should be subject to a clawback of their "profits"[51] is necessarily fuzzy, but it lies somewhere along this continuum:



[49] *See supra* text accompanying note 28.

[50] The trustee, Irving Picard, has argued that investor losses should be the amount deposited into the Madoff firm less any withdrawals, rather than the amount shown on their account statements.

The 2nd Circuit U.S. Court of Appeals in New York agreed.

Andrew Longstreth, *Madoff Trustee's Loss Calculation Method Upheld*, REUTERS, Aug. 16, 2011, *available at* http://in.reuters.com/article/2011/08/16/madoff-2ndcircuit-idINN1E77F0MU20110816.

[51] I'm putting the fake "profits" in quotes to distinguish them from the real profits.

Limiting the reach of the clawbacks to some point at which the investors should have known that they should have been asking Madoff a few questions puts the dividing line between the "haves" / "have nots" near the right place.[52] There's not going to be an exact "aha" moment but, at some point, the investors really should have known. My conclusion puts me squarely in the *Merkin* camp[53] and not the *Katz* camp,[54] mostly because I don't believe that the safe harbor of section 546(e) is a slam-dunk—and it's definitely not a question of law, to be decided before any evidence gets introduced.[55] Without a safe harbor defense, we're back to the "what did they know and when did they know it" inquiry notice issue.

III. CAN WE TELL THE REAL LIGHT AT THE END OF THE TUNNEL FROM THE ONCOMING TRAIN?

Madoff sure seems to have known what he was doing. He cultivated the right people (mostly rich ones), made them yearn for a scarce resource (letting him invest their money), and played into the natural human tendency to want to believe that they can beat the odds (with fake, double-digit, positive returns on phantom money). He lived the kind of lavish lifestyle that most of us will never know, but that most of us wouldn't mind having.[56] Who wouldn't want to have hung out with him in his heyday?

And it wasn't just Madoff. News of the Allan Stanford Ponzi scheme was roughly contemporaneous with the Madoff scandal's news,[57] and there are allegations that Société Générale ignored some of Stanford's red flags.[58] There are more schemes out there that we haven't yet discovered, and there will be others that will begin when the Madoff

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[52] The exact right place is defined by the relevant statutes of limitations. There will always be some people who luck out by being on the good side of a statute of limitation.

[53] *See* Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec., LLC), 11 MC 0012(KMW), 2011 WL 3897970 (S.D.N.Y. Aug. 31, 2011).

[54] *See* Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011).

[55] *See* 35B C.J.S. Fed. Civ. P. § 1158 ("A plaintiff's motion for summary judgment must be denied if affirmative defenses raise matters, which, if proved, may possibly preclude a judgment in favor of the plaintiff as a matter of law.").

[56] Except for the go-to-prison part, and the bankruptcy part, and the being-subject-to-lawsuits part.

[57] *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme (Feb. 17, 2009), *available at* www.sec.gov/news/press/2009/2009-26.htm.

[58] *See* Michael Rothfeld, *Bank Probe in Stanford Case: Prosecutors Are Investigating Whether Societe Generale Ignored Suspicious Transactions*, WALL ST. J., Sept. 16, 2011, *available at* http://online.wsj.com/article/SB10001424053111904491704576572940023060486.html.

scandal dies down. There will be large-scale ones and small ones. And we'll probably keep on letting ourselves get duped.

Humans (even really, really smart ones) have an almost unlimited capacity to fool ourselves, and as Nassim Taleb has pointed out, one of the best ways to fool ourselves is to assume that what we know is all that there is to know—that because all we've seen are white swans, no other types of swans could possibly exist. Add to human nature a modern lessening of our ability to think critically, and you get the recipe for the next round of Ponzi ripoffs.

So, critical thinking is key. At a time when we're questioning the quality of our educational system, I hear a lot about how our students can't write well and how hard it is to encourage them to go into math and science. That scares me. We need good writers, and good writing calls for clear analytical thinking. We need mathematicians, because we need people who understand how numbers relate to each other. And we need scientists, because we need people who are naturally curious about how things work and who want to find out what we don't yet know. We need people who want to ask "why."

We even need lawyers, not just to chase after Ponzi artists, but because good lawyers are always asking "what if" something might happen. Good lawyers are trained to think about black swans. Having a healthy dose of skepticism keeps us thinking about everything from "what if one of the parties wants to breach a contract *this* way?" to "how do we know that the other side really produced everything that we requested?"

Yet there were lawyers and business people and writers who bought into Madoff's fraud.[59] Natural curiosity, a facility with numbers, and analytical ability only work when someone with those talents *uses* them. Maybe the latest round of scandals will sharpen our focus, at least for a while. The clawbacks from Ponzi investors might get our attention, at least for a while. Ultimately, though, we have to keep reminding ourselves that there are black swans in the world. We've already proven that there are ostriches.

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[59] The list included a law dean, some universities, several prominent business people, and Elie Wiesel's foundation. *See* Henry Blodgett, *Bernie Madoff's Victims*, BUS. INSIDER, Dec. 8, 2008, *available at* www.businessinsider.com/2008/12/bernie-madoff-hosed-client-list.