

The Madoff Scandal: Implications and Next Steps



Questions and Answers from The Madoff Scandal: Implications and Next Steps Webinar

Pepper Hamilton LLP
Attorneys at Law

Question: What do you do if in the last six years you took out far more money than you put in, but know you put in money in prior years, but have no records. Original investment started in 1991 and have no records prior to 2001.

Answer: If the Madoff trustee sues to recover payments made within the prior six years, you may have a defense to the extent of your actual investments, but you will need proof (through your own records or Madoff's) of the amounts you invested. Your counsel may be able to procure evidence from Madoff's own records or from the financial institutions on which you drew the checks to make the investments.

Question: To the extent an investor invested into Madoff and had returns of capital and possibly returns in excess of capital invested, is the expectation that any excess would have to be returned, is there an expectation to return any of the capital?

Answer: The Madoff Trustee may well seek a return of both capital and "false profits." Many investors likely will have some level of defense to the extent of capital returns, but will face significant risk on the Trustee's suit to recover false profits.

Question: Were there any investment committees for Madoff's enterprise? Were there ever any private placement memos or brochures that described the investment decision-making process?

Answer: Unclear. The publicly available form ADV does not indicate the existence of an investment committee. The feeder funds and funds of funds that invested with Madoff would likely have prepared and delivered PPMs. As Madoff apparently was not running a hedge fund but rather

managing a series of separate accounts, it is doubtful that he ever would have prepared a PPM.

Question: So if you were an investor in a feeder fund that had an investment in Madoff with a total loss, could the feeder fund apply SIPC indemnification and then they will flow any recovery down to their investors?

Answer: That is the theory, yes. However, given the limits on SIPC protection, you would be sharing with all other investors in that fund on whatever coverage that fund were able to get from SIPC. If the fund was leveraged, it is likely that any recovery would first be used to satisfy the pledge to the lender.

Question: What about assets outside of the United States?

Answer: The Madoff Trustee will seek to recover assets wherever they can be found, and will be able to seek the assistance of foreign insolvency courts in that process.

Question: One would assume that many investors who suffered losses also took distributions from Madoff over the many years of this fraud. Would investors who received distributions from Madoff far less than their total loss be required to disgorge these distributions as fraudulent transfers?

Answer: Many investors likely will have some level of defense to the extent of capital returns, but will face significant risk on the Trustee's suit to recover false profits. If the "total loss" you refer to is lost capital, without consideration of interest, you may well have a defense that you gave reasonably equivalent value for the distributions you did receive.

Question: If an investor sent money to Madoff days before the arrest and the money is still sitting there and identifiable, will it go back to the investor or will it just be “thrown into the pot”?

Answer: The investor would want to immediately consult with his own attorney regarding all of the relevant facts. If the funds were comingled with other funds, such that they could not be separately identified, the investor likely will simply have a claim in the *Madoff* case. If on the other hand the funds were segregated in a separate account, the investor may have an argument that the funds are impressed with a constructive trust.

Question: Has anyone actually seen or indicated that they relied on audit reports of the small firm?

Answer: There is no information publicly available to answer this question.

Question: My question is, was Madoff not a hedge fund but a broker dealer and registered investment advisor? Why is Madoff being labeled a hedge fund? He did not get a 2 and 20 compensation deal, just commissions as I understand it.

Answer: Probably because many of the investors made their investments through feeder funds or funds of funds.

Question: Can the SEC be sued for lack of duty of care?

Answer: A suit against the SEC would not be successful. The SEC is protected by sovereign immunity because it is an agency of the federal government. Although Congress has waived sovereign immunity for torts committed by federal employees in limited circumstances, that waiver does not apply in cases where the acts (or failures to act) were within the discretion of the employee and the agency. Deciding whether to bring an enforcement action is a discretionary act. Consequently, the SEC will be protected by sovereign immunity.

Question: I invested within a partnership with 20 members. Does it make any sense to file a claim with SIPC as one of the individual partners?

Answer: Under the SIPC statute, recovery is limited to one account per customer. Under SIPC regulation, a corporation, partnership or unincorporated association holding an account is considered a separate entity distinct from the person or persons owning such corporation or compromising such partnership or unincorporated association and, recovery is limited to one recovery, without allowance for separate recovery by shareholders, partners or members based on their investment. 17 C.F.R. 300.13. In *SIPC v. Morgan Kennedy & Co., Inc.*, 533 F. 2d 1314 (2nd Cir. 1976), the court limited the interpretation of “customer” to prevent recovery by beneficiaries of a trust. It held that beneficiaries are not “customers” under SIPC.

Question: The former federal prosecutor said something about how SIPC recovery is limited to direct clients of Madoff, and that multiple individuals won't recover if they hold accounts at Madoff via a trust or an LLC. I just want to be clear, because he wasn't very precise: if a trust or partnership holds an account directly at Madoff, that trust or partnership can collect up to \$500,000, right? Your point was that the individual members of the trust won't each recover \$500,000, not that trusts and partnerships can't recover anything, right?

Answer: Under the SIPC statute, recovery is limited to one account per customer. Under SIPC regulation, a corporation, partnership or unincorporated association holding an account is considered a separate entity distinct from the person or persons owning such corporation or compromising such partnership or unincorporated association and, recovery is limited to one recovery, without allowance for separate recovery by shareholders, partners or members based on their investment. 17 C.F.R. 300.13. In *SIPC v. Morgan Kennedy & Co., Inc.*, 533 F. 2d 1314 (2nd Cir. 1976), the court limited the interpretation of “customer” to prevent recovery by beneficiaries of a trust. It held that beneficiaries are not “customers” under SIPC.

Question: Will SIPC pay up to \$100,000 in cash plus \$500,000 in securities, so a depositor could get \$600,000?

Answer: \$500,000 but only up to \$100,000 with regard to a claim for cash.

Question: The discussion relative to the coverage, which is not insurance, but indemnification, I think was that the total coverage was \$500,000 including securities and free cash balances, with a \$100,000 cap on cash. Therefore, inasmuch as it appears that there were no securities (as a Ponzi fraud) that could be replaced by SIPC as it typically does, thus it appears to me that the maximum indemnification per direct client would max out at \$100,000. That would only relate to the cash.

Answer: You are right. SIPC normally replaces securities. What it will do in view of a \$50B Ponzi scheme is anyone's guess at this point. But, indemnification should be based on what appears in the account as of the date and time of take over.

Question: Will SIPC recovery be based upon the "reported" holdings on December 11, 2008?

Answer: SIPC recovery will be based on records as of date and time of take over by SIPC of Madoff Securities.

Question: Is recapturing advances by SIPC determined by how much monies are recuperated from the *Madoff* scandal and how many accounts need to be paid?

Answer: If I understand the question, the answer is yes but, I am not certain that I do, so if you would like to talk through the question, call Frank C. Razzano at 202.220.1286.

Question: Will withdrawals made more than six years ago matter in calculating the recovery? And will SIPC offset the indemnity payout by amounts withdrawn as against the original principal?

Answer: The answer involves an interplay between SIPC and fraudulent conveyance law and, Frank C. Razzano would be happy to discuss it with you if you would like by calling 202.220.1286.

Question: In filing for a tax write-off, can you file for the amount "reported" on the December 11 statement, or just the amount of principal invested (in some case many years ago)?

Answer: At best, the loss is limited to the amount invested, and the amount of "income" that you paid tax on but didn't receive. No tax deduction is available for lost appreciation.

Question: If I invested in Madoff in an IRA, for which taxes were deferred, can I collect SIPC? Can I claim anything as a theft loss?

Answer: On the theft loss, the IRA will be diminished in value, so your taxes when you take out money will be lower because there is less to distribute, but no other theft loss is available.