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Madoff One Year Later: A Litigation Tsunami?

CHRISTOPHER P. SULLIVAN AND LISA A. FURNALD

In this article, the authors discuss the lawsuits resulting from the Bernard Madoff Ponzi scheme.

Bernie Madoff's long running $65 billion dollar Ponzi game was exposed for all the world to see when he was arrested on December 11, 2008. The end of the Madoff scheme signaled the start of a litigation storm that will employ armies of lawyers for many years to come.

MARSHALING MADOFF'S ASSETS

Following Madoff's arrest, the U.S. District Court in New York appointed Attorney Irving H. Picard trustee to marshal Madoff's assets. Picard lost no time in seizing Madoff's records and assets, including his Manhattan penthouse apartment and other residences around the world. Almost immediately, Picard and Madoff's victims realized that only a tiny fraction of the $65 billion dollar scam would be recovered from Madoff's assets on hand. Picard quickly and aggressively sought to claw back assets from third parties and filed suit against several international banks and Madoff's colleagues for alleged preferential payments. Notwithstanding these efforts, one year later it seems all but certain that less than 25 percent of the $65 billion stolen by Madoff will be recovered from his assets.[1]

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THE SECURITIES INVESTORS PROTECTION CORPORATION

Victims who were direct investors in the Madoff funds can file claims with the Securities Investors Protection Corporation ("SIPC"), however such claims are limited to $500,000 per account. As of October 28, 2009, half a billion dollars ($534.25 million) has been allocated for direct investor claims made in the Securities Investor Protection Act liquidation proceeding for Bernard L. Madoff Investment Securities LLC. As big as that dollar amount is, it just does not add a lot to the potential recovery. And indirect investors who invested with Madoff through feeder funds are not eligible for SIPC payment. Do not expect too much help from the SIPC.

WHO WILL BE RESPONSIBLE FOR THE SHORTFALL?

So who will be responsible for the shortfall? Creative lawyers are working hard on behalf of Madoff's victims to recover more of their clients' losses. While Madoff's scheme is the largest to date, the crash of the economic markets in late 2008 has helped lead to the discovery of other sizeable Ponzi schemes and accompanying investor-victims.[2] Although this article focuses on the civil suits filed by Madoff's investors, the litigation strategies employed may be instructive for victims of other Ponzi schemes.

According to attorney Kevin M. LaCroix, who writes a blog called "The D & O Diary," there are 19 separate federal class actions suits involving the Madoff scheme as well as 49 other cases filed in state courts in Florida, California, New York, Massachusetts, Connecticut, Delaware, and New Jersey. Many of the state court cases have been removed to federal court and some are now consolidated in multidistrict litigation proceedings.

The Madoff victims have filed legal actions that target feeder funds, auditors, banks, Madoff relatives and business associates, and various insurers. Some recovery efforts lump most of these targets into a single suit, while other lawsuits focus on a single defendant.

FEEDER FUND CLAIMS

Like all Ponzi schemers, Bernie Madoff needed a constant flow of fresh, new money to keep his scam going. So called "feeder funds" provided a crucial source of money for Madoff that allowed his con to continue. A feeder fund is an investment fund that makes almost all of its investments through a *master fund* via a master-feeder relationship. The master-feeder structure allows asset managers to capture the efficiencies of larger pools of assets. The largest and best known of the Madoff feeder-fund sponsors was Fairfield Greenwich Group ("Fairfield"). Fairfield promoted its funds as a way to tap into Madoff's trading expertise employing "algorithmic technology" while Fairfield claimed to conduct due diligence and "systematic investment compliance." In its Sentry Fund alone, Fairfield invested more than $7 billion with Madoff. Fairfield was well compensated for its work with Madoff, netting over $400 million dollars in fees in just the three years from 2005 to 2008. Fairfield's feeder funds supplied Madoff with money from wealthy foreign investors eager to capitalize on Madoff's supposed investment acumen. Fairfield set up feeder programs with several foreign banks such as Banco Santander, Nordea, Neu Privat Bank, and Cie of Geneva, that provided the fresh, new capital Madoff needed.

On the day Madoff was arrested, Fairfield was working hard to find investors for new Madoff funds, which promised returns up to 16 percent by using greater leverage than had been used in the older Madoff funds. Fairfield allegedly told investors they would be excluded from any future Madoff products if they declined to participate in the new fund and/or withdrew from any existing funds.

Not surprisingly, Fairfield is a defendant in numerous lawsuits brought by its own clients and investors. The principals of the firm have had their property attached and their assets frozen. A class action resulting from the consolidation of multiple cases filed in federal and state court against Fairfield seeks to recoup losses from Fairfield's Madoff investments. The second amended consolidated complaint was filed in the Southern District of New York on September 29, 2009. Besides Fairfield, the complaint also names as defendants the placement agent for the funds, the administrator and subcustodian of the funds and PricewaterhouseCoopers, which audited the funds. The complaint alleges fraud, violations of Rule 10b-5, violations of Section 20(a), negligent misrepresentation, gross negligence, breach of fiduciary duty, third party beneficiary breach of contract, constructive trust, mutual mistake, negligence, negligent misrepresentation, aiding and abetting breach of fiduciary duty, aiding and abetting fraud and unjust enrichment.

Fairfield and other alleged feeder fund sponsors such as Tremont Partners, Meridian Capital Partners, and Austin Capital Management are vigorously defending the lawsuits brought against them. Successfully defending these suits, however, may be an uphill battle. In addition to providing access to Madoff's investment products, the main selling point for the feeder funds was that they offered investors a layer of due diligence to protect their clients' investments. Some plaintiffs now claim that Madoff's fraud was obvious and that the feeder funds performed almost no due diligence. Harry Markopolos, the famous, but unheeded would be Madoff whistleblower, claimed in his television interview on CBS's 60 Minutes that it took him about five minutes to figure out that Madoff was a fraud and about four hours of performing mathematical analysis and modeling to prove it. The feeder funds may have a hard time convincing a jury that their due diligence of Madoff was adequate.

Recently, the Massachusetts Secretary of State settled its lawsuit against Fairfield for $8 million dollars in restitution and $500,000 in costs. This settlement, though small, is the first civil case settled with a Madoff feeder fund. And even though it covered less than a dozen Massachusetts investors, the settlement could well be a precedent for larger claims against Fairfield and other Madoff feeder funds. These feeder fund cases may provide some hope for a meaningful recovery; however, the line of claimants is long and the assets are limited.

AUDITORS

On November 3, 2009, David G. Friehling, the auditor for Bernard L. Madoff Investment Securities, LLC ("BLMIS") since 1991, pleaded guilty to securities fraud and the filing of false audit reports to the Securities and Exchange Commission in connection with Madoff's fraud. Friehling was a sole practitioner operating his accounting firm under the name of Friehling & Horowitz CPAs, PC and reportedly has neither the assets nor the insurance coverage to contribute any meaningful amount to the recovery.

Outside accounting firms, including KPMG which audited Madoff's London operation, have been sued for negligence. Ernst and Young LLP ("E & Y") was the independent auditor for Meridian Capital Partners ("Meridian"), a feeder fund for Madoff's Ponzi scheme. The R.W. Grand Lodge of Free & Accepted Masons of Pennsylvania ("Masons") was an investor in Meridian and has sued E & Y for failure to conduct due diligence and perform proper audits of Meridian. The Masons accuse E & Y of turning a blind eye to many risk factors for Meridian that they contend E & Y should have addressed. The international accounting firm of PricewaterhouseCoopers ("PwC") was the auditor for another feeder fund, Fairfield Greenwich Group. Like E & Y, PwC has been sued by the Fairfield investors who allege that had PwC properly audited Fairfield, the fraud would have been uncovered. Claims against the auditors of Madoff feeder funds could provide some of the deep pockets that the plaintiffs are hoping for.

BANKS

JP Morgan Chase ("JPMC") invested in Fairfield's Sentry Fund, but reportedly withdrew $250 million in September 2008 just months before the scheme collapsed. According to an article in the *New York Times*, JPMC admitted that it had become "concerned about lack of transparency," and the bank's "due diligence people had too many doubts" about Madoff's funds. Madoff trustee Irving Picard has now sued JPMC to recover the $250 million as a preferential payment.

On April 23, 2009, JPMC was served with a complaint from a Florida partnership investment company called MLSMK that directly deposited $12.8 million into Madoff's account between October and early December, 2008. The lawsuit alleges that JPMC aided Madoff's crime by maintaining his checking accounts and trading with his brokerage firm long after the bank realized that he was running a vast fraud. The complaint alleges that if JPMC had terminated Madoff's accounts at the bank when it began withdrawing its own money from the Fairfield Sentry Fund, then the plaintiffs would not have lost their money.

On October 20, 2009 an amended complaint to an investor lawsuit in New York state court added JPMC, Bank of New York Mellon, and the accounting firm KPMG. Also named was Oppenheimer Acquisition Corp, Massachusetts Mutual Life Insurance, Tremont founder Sandra Manzke and former Tremont Chief Executive, Robert Schulman. The amendments were reportedly based on the plaintiffs' attorneys' prison interview with Bernard Madoff in July, 2009 as well as the law firm's own investigation. "The complaint alleges Bernard Madoff's fraud was not accomplished in isolation," the law firm's statement said. "The sheer size and scope of the fraud make it impossible for Madoff to have acted alone."

INSURANCE CLAIMS

There are at least six Madoff related cases that concern the existence of insurance coverage for the Madoff losses. In one of these insurance coverage suits, the plaintiffs represented by the Milberg law firm have filed a class action against AIG and other insurers seeking a declaration that the Madoff losses they suffered are covered under their homeowners' policies that provide "Fraud and SafeGuard" coverage. In another insurance coverage suit, Upshur-Smith Laboratories, Inc. ("Upshur-Smith") is suing its Employee Benefits Plan Administrative Liability insurer. Upsher-Smith had invested $12 million dollars in its profit sharing plan with Bernard L. Madoff Securities LLC and is now alleging that its losses as well as fines and reimbursements it was ordered to pay by the U.S. Department of Labor are recoverable from its insurance policy. Upshur-Smith has also filed an action with its crime insurer in connection with separate losses the company itself suffered from investing with Madoff. Upshur-Smith's insurance carriers have denied coverage.

CONCLUSION

Bernard Madoff operated the largest individual Ponzi scheme ever uncovered. He pled guilty to 11 felonies and on June 29, 2009, he was sentenced to 150 years in prison. It has been little more than a year since the Madoff scandal broke, so it is too early to know how successful the legal actions against third parties will be. What is certain is that a lot of lawyers will be working for a long time on the mess Madoff made.

NOTES

[1] Financial fraud investigator Harry M. Markopolos estimates that $35 billion to $55 billion of the money Madoff claimed to have stolen never really existed and was simply fictional profits he reported. Markopolos believes that Madoff's clients lost $10 billion to $35 billion, most of which went to early investors.

[2] According to Associated Press analysis, over 150 Ponzi schemes imploded in 2009 compared to approximately 40 in 2008. *See* Anderson, C. "Ponzi Collapses More Than Triples in '09 as Investors Lost About $16.5B," usa.com, December 9, 2009. Among the more notorious implosions are Texas financier Robert Allen Stanford's alleged multibillion dollar scheme involving certificates of deposit and Florida lawyer Scott Rothstein's alleged $1.2 billion scam. Mr. Stanford and Mr. Rothstein have both pleaded not guilty to federal charges.