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An Update: Madoff Proceedings and Trustee's Suit Against the Fairfield Defendants

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It has been nearly two years since Bernie Madoff was arrested in his Manhattan home and criminally charged with a multi-billion dollar securities fraud scheme operated through the investment advisory unit of Bernard L. Madoff Investment Securities LLC (BLMIS). Madoff spent decades building the world's largest Ponzi scheme, so what has been going on since the appointment of Irving Picard as liquidating trustee in December 2008? As one could imagine, quite a lot. That being said, an attorney in Picard's firm of Baker Hostetler recently noted that there are lawyers yet to be born who will work on the Madoff proceedings. Though much has transpired, it seems we may only be approaching mile marker one of a marathon.

Most activity is in the Second Circuit, where the appeal of Judge **Burton R. Lifland**'s March 1, 2010, opinion approving Picard's "net-investment" method of determining customers' claims in the SIPA liquidation proceedings is at issue.[1] Stay tuned, as the net equity issue has been extensively briefed by the trustee/SIPC and investors, along with several *amicus* briefs from the Securities and Exchange Commission (SEC) and nonprofit organizations.

December should be an extremely active month in the case. According to the *Wall Street Journal*, Mr. Picard's firm is preparing numerous "clawback" lawsuits against approximately 1,000 individuals to recoup funds from Madoff investors who received more in principal distributions than they invested with him.[2] Undoubtedly, these clawback suits will lead to much more controversial and emotional litigation.

While we wait for news out of the Second Circuit and for the wave of clawback

lawsuits against investors, one of the first—and most interesting—clawback actions is against Fairfield Sentry Limited and related entities.[3] On July 20, 2010, Picard filed a 217-page amended complaint, amending the original complaint filed more than one year earlier. The amended complaint named 43 additional defendants, including 24 Fairfield affiliated entities and 19 individuals. The complaint also named the three co-founders of Fairfield: Walter Noel, Jeffrey Tucker and Andres Piedrahita. In summary, where the original complaint alleged that Fairfield missed so-called red flags of a Ponzi scheme, the amended complaint goes a significant step further: alleging that in addition to missing red flags, the defendants were *de facto* partners with Madoff. According to Picard, Fairfield served "as one of Madoff's largest marketing and investor relations arms, the Defendants were active participants in, and substantially aided, enabled, and helped sustain Madoff's Ponzi scheme.[4]"

Fairfield and related entities, though now in liquidation proceedings of their own, offered feeder funds, and at one time, claimed to have $16 billion in assets under management. Fairfield entities maintained several customer accounts at BLMIS and, as alleged by the trustee, were collectively among Madoff's largest sources of investor principal. According to Picard, "for BLMIS to survive as a Ponzi scheme, it needed massive, regular injections of cash to fuel the scheme," which hedge funds and funds of funds similar to Fairfield could provide, and the hedge fund arena in which the Fairfield funds operated provided a friendly regulatory environment.

The amount of money that passed between Fairfield entities and BLMIS is staggering. In the aggregate, the Fairfield feeder funds allegedly deposited almost $4.7 billion and withdrew approximately $3.2 billion before the discovery of Madoff's scheme. The amended complaint seeks to recover investor funds from two types of defendants: (1) feeder funds (in the aggregate amount of their $3.2 billion in withdrawals) and (2) individuals that received significant compensation for their roles in managing the feeder funds or selling investment products to investors.

Taking the amended complaint at face value provides not only an interesting insight into the inner workings of Madoff's scheme (sometimes reading like a John Grisham novel), but more importantly to our field, provides insight into Ponzi scheme red flags. Ultimately, Picard's successful recovery against Fairfield entities and individuals may hinge on his ability to show that the Fairfield defendants made billions of dollars in an environment where numerous Ponzi scheme red flags flew, but were still ignored. Some of the most noteworthy red flags that the trustee alleges were ignored are summarized below.

> 1. *Madoff told investors that his success was based on his split-strike conversion strategy.* The strategy involved investing in a basket of securities in the S&P 100 at opportunistic times and liquidating the

securities and rolling the money into treasury notes several times a year. The sale of tens of billions of dollars in U.S. securities over just a few days would have a clear impact on the market price of the securities bought and sold. Picard alleges that sophisticated investors such as the defendants should have known that without evidence of such a market footprint, the trades were not occurring.

2. Certain trade anomalies, such as receipt of trade confirmations, indicated that Madoff traded stocks at prices that were outside the daily ranges of prices for those stocks. In other words, Madoff, on several occasions, made the mistake of documenting the sale of or purchase of securities at less or more than what was possible in the market.

3. *According to Picard, quantitative analysis that is standard in the hedge fund industry revealed that Madoff's positive, consistent returns were statistically, highly improbable.*

4. *Despite Madoff's multi-billion dollar operation, his auditor was a one-man firm operating in a strip mall.* Madoff sometimes claimed that he had a family connection with the auditor, and other times denied any family connection. Picard alleges that after the Bayou Ponzi scheme was uncovered, the defendants used the press coverage around Bayou and its use of an obscure audit firm to convince their investors that a Bayou-like fraud could never happen to Fairfield, because Fairfield would have "questioned Bayou's obscure auditing firm."

5. *A common perception among industry analysts was that Madoff's perfect timing based on market flow was indicative of illegal front-running.* Picard alleges that the defendants did nothing to investigate this well-known industry rumor. Additionally, industry experts warned of potential fraud within Madoff's operation, or at least that he "was not going by the rules."

6. *The options trade confirmations that the defendants received from Madoff did not comply with industry standards.* For instance, none of Madoff's options trade confirmations properly identified a counterparty.

7. *The defendants did not know the exact amount of Madoff's assets under management, and admitted that "there [was] no check on the amount of money that he manages."*

8. *According to Picard, Madoff's explanations of the split-strike strategy often changed according to the circumstances, a red flag that the*

defendants did nothing about.

Almost certainly, the argument that an investor knew or should have known that Madoff operated a massive Ponzi scheme will play out repeatedly over the next several decades. Logically, if any entity or individual knew or should have known about the scheme, it was the Fairfield defendants.

1. *See* "The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part IV," *ABI Journal* (May 2010) for a discussion on this ruling.

2. *See* "The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part III," *ABI Journal* (April 2010) for a discussion on a trustee's ability to recover interest and principal distributions in Ponzi schemes.

3. Adv. Pro. No. 09-01239 (BRL), pending in the U.S. Bankruptcy Court, Southern District of New York.

4. All quotations herein are from the Trustee's Amended Complaint, Docket No. 23

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