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Payback time?

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The multibillion-dollar Madoff scandal has shaken Wall Street to its core, but the fallout will be felt far outside the US. By Phillip Kite



The Madoff scandal appears to be one of the largest frauds of all time and, although perpetrated from the very heart of Wall Street, this fraud has huge repercussions outside the US.

Some of the thousands of victims include investment funds in the Cayman Islands and the British Virgin Islands (BVI). The figures are truly enormous, and investors found out that investments worth billions in November 2008 might now be worth a tiny fraction of that sum.

Madoff

Salt has been rubbed into the wounds by the actions threatened and taken by the bankruptcy trustee (the trustee) of Bernard L Madoff Investment Securities (BMIS), and although the offshore funds have been the victims of this onshore fraud, they may now be litigation targets.

US claims

The trustee has an armory of powers to claw back payments made by BMIS, including against those funds that received otherwise standard redemption payments in the run-up to Madoff's arrest. For example, the trustee may demand back payments made out of BMIS in the 90 days before the date of liquidation, and also previous transactions going back years that the trustee regards as 'fictitious profits'. These actions have already begun against at least four BVI funds, some of which are claims in excess of \$100m (£61.73m), and could tip these companies into liquidation.

Investor claims

Funds should look out for a number of potential claims:

- Investors as creditors: numerous investors submitted redemption claims that were not paid, or provided funds that were never invested. Great care will need to be taken to decide if they are investors or creditors - if they are creditors in sufficient numbers, the fund may be insolvent.
- Shareholders actions: investors are starting action groups that might give them more of a

say in Madoff-affected funds. Investors in one BVI fund, where losses are said to be \$7.5bn, have now started liquidation proceedings, which if successful could start other similar proceedings, and a large derivative action has now started in the US against another Madoff-affected fund.

- Misrepresentation: inaccurate statements made by funds or persons connected with them are fertile areas of litigation and funds should check their marketing material and other fund documents.

Directors

As Madoff created a club-like atmosphere, investing into BMIS may have seemed like a privilege before December 2008. It does not look so good now.

As well as potential derivative actions and misselling claims, directors need to consider carefully whether normally solvent structures are now insolvent. This is highly relevant if those structures subsequently go into liquidation, as directors can be personally liable for the debts of a company if, for example in the BVI, they knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation and thereafter failed to take every step reasonably open to minimise the loss to the creditors.

Investment managers

Managers are clearly in the firing line for claims and much will depend on what due diligence was undertaken and what an investment manager knew about BMIS.

Managers should be particularly concerned with actions in the US (some of which have already started), where not only are discovery rules extensive, but damages are generally higher. Given the current climate, it is also doubtful that a BVI or Cayman management company will receive a very welcome reception in the US courts.

Auditors and banks

The targets with the deepest pockets are often the most popular, and most of the big banks and auditors face potential exposure. Some banks commonly promoted funds to their clients and, while in the good years this is the sort of in-house banking product that was popular with customers, the banks probably now wish they had diversified more.

Auditors are always a target, but not an easy one, as the auditors will no doubt fight back very hard against claims. Importantly, most audit engagements may not be under US law, although if audit teams visited BMIS in the course of their duties then this might lead to allegations of 'Nelsonian' blindness. Such claims could be damaging to reputation as well.

In several large claims against offshore funds, the trustee has joined the custodian bank as a second defendant, sometimes on dubious jurisdictional grounds. However, the trustee's tactics are to draw as many deep pockets as possible into the New York courts and banks with other significant US assets may have no alternative but to defend in the US.

Madoff, formerly chairman of Nasdaq and a Wall Street icon, has left a huge mess in his wake. It is right and proper that he pay for his crimes, although it is unfortunate that the regulators who seemingly failed to do their jobs may get away with their failure to detect the largest Ponzi scheme we have ever seen.

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