Madoff Case Discussion

Christie	Good afternoon. My name is Christie, and I will be your conference operator. At this time, I would like to welcome everyone to the Bernard Madoff case discussion, hosted by Proskauer Rose. All lines have been placed on mute to prevent any background noise. Thank you. I will now turn the conference over to Mr. Jay Waxenberg. So, you may begin.
Jay Waxenberg	Thank you. Good afternoon, and welcome to our conference presentation on Madoff investments. I am Jay Waxenberg, a member of the firm, and Chair of the Proskauer Rose Personal Planning Department. As we all know, last week Bernard Madoff, the principal of Bernard L. Madoff Investment Securities, was arrested by the Federal Bureau of Investigation agents due to an alleged fraud. Although the facts continue to develop, it appears that Mr. Madoff ran what is characterized as a Ponzi scheme. This unfortunate event has affected many of our individual, institutional and charitable clients, both financially and emotionally. We have received a large number of calls from our clients concerning the recovery, tax, and other matters. Proskauer Rose has put together a task force of litigators, securities experts, tax attorneys, insurance coverage attorneys, and bankruptcy attorneys who have been studying the complicated issues our clients are now facing. The purpose of this call is to make available to you our current thinking on the various issues. We have assembled a group of experts who have been

closely following the Madoff case. Speaking today will be Gregg Mashberg, Ed Kwalwasser, Shelly Hirshon, Sol Warhaftig, John Failla and Sarah Gold. I will let each speaker give you their individual background.

A couple of housekeeping items before we begin. This is a one-way call. We have received a large number of questions from you in advance, which we will try to cover during the call. Also, this conference call will convey information; it is not intended to provide legal advice. We can only give you general information and clearly nothing in the call is privileged or confidential. We can obviously be contacted for individual advice.

That being said, let's get started. Our first speaker today is Gregg Mashberg.

Gregg Mashberg

Thanks, Jay. And good afternoon, everybody. I'm Co-Chair of Proskauer's Security Litigation Practice Group and former Chair of the firm's Litigation Department. I want to set the procedural context of our discussion today. As the FBI was arresting Madoff last Thursday, December 12, the SEC rushed into court to obtain an Order to appoint a receiver to take control over the assets of Madoff and his firm, Bernard L. Madoff Investment Securities, LLC, oftentimes known as BMIS. On Friday afternoon, the next day, December 13, U.S. District Judge Stanton granted the Order, freezing both Madoff and his firm's assets and appointing a well-known lawyer, Lee Richard, as a receiver for BMIS.

Judge Stanton also stayed any creditors or claimant from taking any action against BMIS or Madoff. We were in court on Friday, and there were at least 100 lawyers in the courtroom. There is a hearing scheduled for this Friday, December 19, before Judge Stanton, to continue this stay.

Because BMIS is a registered broker/dealer, its failure triggered the involvement of the Securities Investment Protection Corporation, a private non-profit corporation funded by its member broker/dealers and established by federal law. SIPC, as it is known, ensures brokerage accounts in the case of brokerage firm failures. Ed Kwalwasser is going to discuss SIPC in a minute. As part of a standard procedure in matters such as this, Monday, December 15, SIPC went to court and obtained an emergency order appointing Irving Picard as the Trustee over BMIS, supplanting the authority of Mr. Richards, with respect to the firm, who was the receiver. Mr. Picard is a former U.S. Trustee in the Bankruptcy Court here in Manhattan. His role is analogous to a Trustee for Chapter 7 bankruptcy litigation to oversee the liquidation of BMIS. He is very experienced and an excellent choice for this position.

The law firm of Baker & Hofstetler will serve as counsel to the Trustee. Mr. Richards, the Receiver, will maintain authority only for Madoff International.

The Order that Judge Stanton issued on Monday, December 15, also stayed all legal proceedings against BMIS under the same automatic stay

provision that applies in bankruptcy cases. Again, as a standard procedure, Judge Stanton sent the entire matter to the U.S. Bankruptcy Court in Manhattan, and the case is assigned to Bankruptcy Judge Peck, who is the same judge presiding over the Lehman bankruptcy case. In the meantime, all litigation against BMIS will remain stayed, and the Bankruptcy Court will oversee the marshalling of BMIS assets for the benefit of its creditors, as Shelly Hirshon will explain in a minute.

Under the outstanding court order, nobody may remove or withdraw assets or property under control by, or in the possession of, BMIS. There are narrow exceptions to this however, established by various federal statutes, largely relating to the settlement of outstanding securities transactions. I will conclude this with a little introduction, by noting, as you may have read in this morning's newspapers, that in the criminal case against Mr. Madoff, a bond hearing was scheduled for yesterday, but adjourned until today. The question is whether Mr. Madoff is cooperating with the prosecutors, which will be very, very important if they are going to be able to track down any existing assets. Ed Kwalwasser is now going to talk about the SIPC liquidation process. Ed.

Ed Kwalwasser I am Ed Kwalwasser, Senior Regulatory Counsel at Proskauer, and former Head of Regulation at the New York Stock Exchange. As Gregg stated on Monday, a SIPC trustee, Irving Picard, was appointed to liquidate Bernard Madoff Investments Securities, LLC. The SIPC trustee, upon review of Madoff's books and records, will send a notice to all customers listed on

the firm's books as well as a claim form setting forth dates upon which all claims must be filed. Although this process does not usually take a long time if the books and records of the broker are in good order, we understand that the books and records in this matter are not in good order, and so, at this point, we cannot estimate when claims will be able to be filed. SIPC insurance is only available to accounts at the broker/dealer, Bernard Madoff Investments Securities, and not accounts that invested with Madoff through feeder funds, or investment advisors. In such a case, the funds of the advisor themselves would be a client covered by the SIPC fund. To determine whether you are a client of Madoff Securities, you should review any documents that you may have. The SIPC fund will pay up to $500,000 per account. However, multiple accounts for the same name will be viewed as a single account. But, an individual account and a family foundation or an IRA account will be viewed as separate accounts, each entitled to $500,000 coverage. Once you receive a claim form, you will be asked to set forth all claims for cash and securities. You would have a claim for securities if you received a confirmation, a monthly statement showing securities position, regardless of there being actual securities at Madoff. You should provide the documents showing the transactions claimed, including checks, confirmations, and monthly statements. The Trustee will advance up to $500,000 per account when the claim is approved. The SIPC Trustee, however, to the extent it is

practical, will be required to deliver securities rather than cash. It is not clear how it will do so in this matter.

Next, I would like to introduce you to Sheldon Hirshon, who will deal with provisions of the Bankruptcy Act.

Shelly Hirshon

Good afternoon. This is Shelly Hirshon. I am a senior lawyer here, at Proskauer Rose, and Co-Head of the Bankruptcy and Restructuring Group. I will talk about the general course of the SIPC bankruptcy case, and then specifically about how the SIPC Trustee, Mr. Irving Picard, will supervise the bankruptcy proceeding, including the distributions paid by the firm to investors over these past years. At the outset, you should all keep in mind that there was only one entity involved on the U.S. side. Bernard L. Madoff Investment Securities, LLC. Your account statements noted that there is a U.K. affiliate, Madoff Securities International Limited. All of my remarks will focus on the U.S. entity, and I will refer to it as the Company.

The Company conducted both market making activity and investment advisory services for which you invested with him. And, I know that some of you received and deposited money through JPMorgan Chase. We do not know the relationship of Chase to the Company. That and all other aspects of where the money went is a subject of the ongoing investigation by the SEC, the U.S. Attorney, the newly appointed SIPC Trustee, and others, and we will not comment on it further. I will focus on the trustee's

handling of the SIPC handling proceeding for the Company. And first, general concepts.

It is the Trustee's duty to collect all of the assets belonging to the Company, and after the expenses of running the estate are paid, pay whatever money is left to validated claims. And, this would be in addition to the SIPC coverage. Based on the information publicly available up until now, there is likely to be very little, if any, money coming out of the Company.

Now, let's talk about the distributions paid by the Company. The federal and state courts have extensive experience handling Ponzi schemes. And there is a recognized body of law which we have reviewed. Under the Bankruptcy Code and New York State Law, the Trustee may sue to recover distributions that meet certain requirements and the look back period is six years. Many of you have already heard about this, and may have heard the terms "fraudulent conveyance" or "fraudulent transfer." That is the technical title of these laws, and the fraudulent part refers to Madoff, and it has nothing to do with you. The general concept of the fraudulent conveyance law is that either the transferor, here the Company, actually intended to hinder, delay, or defraud creditors. The second basis for a fraudulent conveyance in which the transferor, again the Company here, received from the Transferee -- and that would be you -- less than a reasonably equivalent value in exchange for the property transferred, and the Company was either insolvent on the date the transfer was made, or

was made insolvent by the transfer, or the Company was engaged in business for which the property it held was an unreasonably smaller capital, or the Company intended or believed it would incur debts that it could not pay, as those debts matured. It's difficult to understand, so let me provide an example, as a gift.

If I give you my home as a gift, I receive nothing in exchange for it. There is no reasonably equivalent value coming back to me. If my total assets are valuable enough, so that I am not insolvent after the gift, and I am not made insolvent by the gift, there is no fraudulent conveyance, because my asset pool is still enough to cover my creditors. However, if my asset pool would be reduced below that level, so that my creditors may not be repaid in full, the transfer is voidable. And here you see the intent of the law, which is to provide the equality of treatment among creditors by denying the transferor the ability to prefer some creditors over others, or to hide assets by parking them in friendly hands.

Now, let's apply these concepts to the Madoff matter. By definition, the Ponzi scheme was a fraud perpetrated by the Company. It meets the first test of the fraudulent transfer, an actual intent to defraud creditors, and under this test, the law focuses on the Company's intent, not yours. Under established case law, the distributions that are the return of capital -- and we call those redemptions, commonly -- are subject to recall, subject to an exception known as the value and good faith defense. If the facts fit this exemption, it provides a safe harbor which will protect redemptions. To

meet this exception, you must have provided value in return for the redemption and have taken the redemption in good faith. The value part of the exception is easy. The law holds that the investors have rescission claims against the Company, in an amount equal to the investment, and that represents the value given up in return for the redemption. A claim against the Company equal to the redemption payout.

The good faith component is the troublesome part, and sometimes a very hotly contested matter of fact, that has to be tried by the Court. The law is established on this issue, but the application is difficult. The statutes do not define good faith, but the courts have developed a consensus that good faith is determined according to an objective or reasonable person's standard, not on the subjective knowledge or belief of any particular person. Courts look to what the transferee -- you -- objectively knew or should have known, and not on your personal knowledge. Therefore, a person did not act in good faith when he has sufficient knowledge to place him on inquiry notice of a possible fraud. And, a person who is on inquiry notice, if it knew or should have known of the red flags placing it objectively on alert that there was a potential problem with the company, such that the person should have attempted to learn more. Once a person is on inquiry notice, his failure to do a diligent investigation destroys the good faith defense. You can't hide in the sand.

In order to prove good faith, the investigation must resolve the red flags that were raised in the first place, and if a person saw a red flag, and made

a diligent inquiry, and still kept the money with the Company, the good faith defense would be proven. But, it is more likely that the person would have redeemed. And in that case, the reason for the redemption becomes relevant, and the Court will investigate the person's subjective reason for the redemption. Was that person acting because of the red flags, or for an innocent reason unrelated to the warning signs, such as money was needed to pay tuition, etc.? As you can see, the good faith issue was a case-by-case examination, and the exact, particular facts need to be examined. So, assuming the value and good faith defense is met, the redemptions will be protected. Unfortunately, the same cannot be said of distributions that represent earnings or profits on the invested capital.

Here, the courts hold that there cannot be any reasonably equivalent exchange. The investor gives up nothing in return for the earnings. So, these distributions are inherently fraudulent, and not subject to any safe harbor protection or defense.

The toughest issue we are still investigating is how to characterize any particular distribution, is it a redemption and subject to the value of good faith defense? Or, a fictitious profit, in the language of one case and not subject to any defense? So, let me summarize by saying the money received as redemptions is protected by the value of good faith defense, while the money received as earnings is at risk.

Now let me turn this over to Sol Cohen. I am sorry. Sol Warhaftig, who will talk about tax aspects.

Sol Warhaftig: Good afternoon. I am Sol Warhaftig, a partner in the Proskauer Tax Department, and I wanted to summarize, in a brief way, the very significant tax benefits that may be available with respect to the loss incurred on the Madoff investment.

For tax purposes, the losses should be thought of as being in two categories: First, the losses relating to amounts invested, and, second, losses relating to prior inclusions of income that were reported to the investor as income earned, even though we know now that that it wasn't. And payments of taxes that were made by investors with respect to that income.

Looking first at the losses of investment, there the law is clear that on the basis of the facts, as we know them, a theft loss will be available. This is a very good loss from a tax standpoint. It is an ordinary loss that's deductible against ordinary income. It is not subject to limitations, like the 2% floor, and it does form the basis for what's known as a "net operating loss," which carries back, with regard to a theft loss -- it carries back for three years -- and it is available to carry forward for 20 years.

So, this loss is very effective. The one issue that a situation like this presents is that one cannot claim the loss, or qualify for the loss, until there is no reasonable prospect of recovery, and by that we mean uncertain

amounts, so that if one is anticipating a SIPC recovery, that we know the amount, and that would simply be a deduction from the amount of the loss. It would reduce the amount of the loss, and the balance would be available.

On the other hand, until there is a better picture of what other assets may be available, it's difficult to determine whether there is any reasonable prospect of recovery, although the facts that we have been hearing suggest that there will be no reasonable prospect of recovery. But, this means that one is going to be listening very closely to the news that comes with regard to this matter during the next couple of weeks, up to the end of this year, to see whether there is a position that there is no reasonable prospect of recovery beyond the SIPC amount, and therefore, there is a theft loss deduction in the year 2008, with the benefits that would produce.

The law is a lot less clear when it comes to the loss of income that was reported to the investor, and that the investor was taxed on. There, there are two possible treatments. One being the elimination of the income from prior year returns. One would simply file a supplemented return, and say, "I didn't have that income really. It was phony income. It was reported, but it wasn't really there." That would work fine with respect to the three years that are typically open under the statute of limitations. But, years prior to that would presumably be blocked in almost every situation, unless there is an ongoing audit, and there are waivers of the statute in place. So, that if an investor has been in the program for a lot longer than

three years, and hasn't been taking out earnings, the statute of limitations would be a serious impediment, a balance lost forever. The second possible approach would be not to eliminate, what I will call the "phony income," but rather to claim a theft loss, an additional theft loss, with respect to the income reported and never received, and there is authority -- or at least there is an indication that the IRS is willing to go along with the second more favorable route. There is a 2004 Memorandum from the National Office of the IRS in Washington to a field office indicating that that's the appropriate way to go. Unfortunately, this is not precedent that can be relied on, and it's pretty certain that the government will take another look at this in the light of the current situation, and so, there is a decision to be made which way the government will go. And, it's not clear how this will turn out if the government doesn't go along with it, and people actually litigate it. I think there is a position, but it's uncertain. Assuming that route two, the additional theft loss is the correct route, there is a possible additional position, which would be very, very helpful to the investor who has been in the program a long time without taking out earnings. And that is, there is a provision of the Internal Revenue Code, § 1341 referred to as the Claim of Right Rule, which says that, if it is available, then I as an investor can go ahead and claim now in effect a refund for all of the money that I have paid for, all of the years going back including the years that are barred by the statute of limitations, so there would be no limit. All years are available. Unfortunately, there is no

authority dealing with this section in this sort of situation, and the Government has generally resisted the people's attempts to use this section to go back and recover amounts out of statute-barred years. So that, in summary, there is a major factual question relating to the availability of additional assets to provide additional recovery, and that may delay the ability to obtain these theft losses, and there also are major questions about the treatment of the losses relating to income that was taxed, and isn't there.

John Failla

Thank you, Sol. My name is John Failla. I am a partner in the Litigation Group here and a member of the National Insurance Recovery Practice at Proskauer. I want to talk a little bit about some of the non-SIPC insurance potential areas of recovery for these losses. I have been litigating coverage cases involving Ponzi schemes, similar fraud, for many years, and there are a lot of potential options that might not be apparent at first glance. Insurance issues are often the last things thought of in circumstances like this. It's an important thought that they become part of the early stage issues, for reasons that I'll discuss. It is not always apparent, again, at first glance, whether and which types of insurance policies might provide coverage for these sorts of losses -- insurance policies are not written in plain English. They are not organized documents. They are, in fact, completely disorganized documents, negotiated and amended in a variety of haphazard ways. So, often you find the best coverage available for losses like this in sections and areas of

policies with descriptions and titles that wouldn't give you any indication at first glance that would apply. But, there are a number of potential areas of policies and types of policies to consider. And, I'll just discuss a few of them by way of example.

In the individual circumstance, a place to start would be individual home owner and property policies. Certainly, the primary coverage grants of those policies, fire, theft, etc. are not what would apply here. But, the language of those policies is not uniform. There often are a tremendous number of add-ons, and different types of coverage that are provided. The coverages are various. You will find them in endorsements with non-descriptive titles. Just by way of example, of a type of revision in a home owner's policy that, in my view, could provide coverage for these losses is from an AIG private client group home owner's policy, current form, that typically contains an endorsement and extension of coverage called "AID Fraud Safeguard Coverage." The main intent of it is to protect against identity theft, ATM robberies, different types of criminal conduct. They certainly probably did not have a Ponzi scheme loss in mind when they drafted this. But, insurance policies are construed broadly in favor of policy holders, exclusions are read narrowly, and to the extent the plain language of the policy will support a recovery, then a policyholder has a more than a fair basis to claim that recovery. This particular endorsement, and it's one of many on market, covers a variety of prime losses, including what it labels "fraud or embezzlement." And it covers loss of money,

securities or other property, either from forgery or from what the endorsement describes as any intentional perversion of truth -- it sounds like a lie to me -- by someone other than you or a family member, perpetrated in order to induce you or a family member to part with something of value. Certainly sounds like what Madoff did here in running a Ponzi scheme to deprive people of considerable money and property. There are other insurers who have similar types of coverages. They use different language. They are in different places. But, that is potentially something that could provide a partial recovery. There are often strict rules both in the policies themselves, and in the law surrounding those policies, that provide strict timetables on when notice of losses and claims has to be provided and when proofs of loss have to be submitted. And oftentimes, it is very important to give very prompt notice of a loss or the claim is forfeited. That is particularly true in New York where we have the worst notice law on the planet. And, so these are issues that have to be considered at early stages, not down the line, when you see how everything else arises.

So, the general approach really should be to collect an inventory of all of the policies that you have in force. To have them reviewed, not based on their summaries, or based on what an agent or a broker might tell you from recollection. But really to review the language and to have them viewed by insurance professionals with an open mind -- with an eye to see whether or not there is any potential basis to claim coverage for this type

of loss, and certainly, you will find more often than not, that there is some avenue available to provide a partial recovery. That's in the individual case. Certainly, for the institutional contacts, where assets are invested through asset managers, advisors, fiduciaries, feeder funds, and the like, it is likely that those institutional holders also have their own insurance coverage, their own investment management coverage, their own fiduciary liability coverage, their ERISA bonds, their fidelity bonds, that should be endorsed in a way to provide coverage for the activities of off-site managers that commit fraudulent and dishonest conduct that results in a loss of the investment.

So, to the extent assets are held in those areas, there should be additional sources of policies, often with very substantial limits and very broad coverage to allow for recovery of additional losses. And so, really, the overriding point here is to look at insurance with an open mind and, most importantly, look at it early, because otherwise the potential avenues of recovery might well be forfeited.

With that I would like to turn it over to Sarah Gold for further thoughts.

Sarah Gold — This is Sarah Gold, Co-Chair of the Securities Litigation Practice Group, and a former federal prosecutor in the Securities Division of the United States Attorney's Office in Manhattan. You have now heard from various experts about the issues to consider. The next question is, what do I do now? Since, as you have heard earlier from Gregg, the federal court has

stayed all litigation against the Madoff firm, any civil law suit against the firm are stayed and will not be moving forward. It will be up to the Bankruptcy Court to determine whether to lift the stay, but in prior cases, I can tell you, the stay has often remained in place for many years. There can be class actions brought against third parties. The way class actions work is that you do not need to take any actions to join the case. If you come within the definition of the class set forth in a complaint, you are included in the law suit. At a much later stage in the litigation, you will be given an opportunity to opt out of that law suit if you should choose to do so. Also, I want to tell you because many people have e-mailed us asking this question, about suing the SEC; the Securities and Exchange Commission is not a feasible avenue for a republic. However, there are a number of things you can and you should do.

As Ed mentioned earlier, SIPC has said that the Madoff firm records are not in good order. Therefore, it is essential you gather your own documentation and be sure that it is in order and complete. If you invested directly with Madoff, include all signed documents such as your account opening agreement, and any other documents you may have signed, all account statements you have received, any sales literature, correspondence or other documents sent to or received from the Madoff firm. And all other evidence of the money you invested with the Madoff firm such as checks, wire transfers, or instructions to other financial institutions to transfer funds or securities to Madoff. You should gather all of your

records relating to receipt, that you received from the Madoff firm of your deposits. This could be extremely important as proof of what entity it is that your money was deposited into. SIPC insurance, as you heard earlier, applies to the Madoff broker/dealer, which was called Bernard Madoff Investment Securities, LLC. But SIPC does not apply to any funds deposited with other entities Madoff may have been operating. Therefore, if your money was deposited into an entity different from the broker/dealer, your deposit may not be covered by SIPC insurance. An opinion about SIPC coverage for you would require a full evaluation of your individual documents. Second, you should review your individual situation. Did you invest your money directly into the Madoff firm? Did you invest it through a feeder fund or through an investment advisor? If you invested through an investment feeder fund or an investment advisor, you may have separate claims, and if you are a representative of a feeder fund or investment advisor, you will have defenses. In each of these instances, you will need specific advice, which we would be happy to discuss with you on an individual basis, to assist you in determining how to proceed. However, again, it will be important for you to gather, and have in order, all of your documents relating to your investments.

The third thing that you may wish to do is to consult with other advisors, including your financial and tax advisors and insurance experts, with respect to some of the issues we have raised today. Since we have received so many calls from clients and firm friends seeking information

and advice regarding the Madoff situation, we plan to represent groups of similarly situated clients in a cost-effective manner, as well as the individual interests of clients where appropriate. If you are interested in such representation, please call your lawyer contact here at the firm, or if you do not have a contact here, please e-mail us with your contact information at the address noted on the invitation to this conference call. You may also call any one of the speakers on our panel today, and we would be happy to assist you. We hope this conference call has been helpful to you. And, we expect to continue to schedule conference calls when we believe we have information of general interest to provide to our clients. Thank you very much for calling in today.

END