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PLAN ALERT

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RELEVANT, CURRENT CASE SUMMARIES FOR PROFESSIONAL LINES CLAIMS PROFESSIONALS

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SPOTLIGHT Alert: Legal Minefield Grows for All Concerned as Madoff Claims Mount

The scope of the Bernard Madoff Ponzi scheme, with thousands of investors losing as much as $50 billion, is yet unrealized. Investors' efforts to recover their money are already being directed at banks, accounting firms, financial advisors, auditors, insurers, and so-called "feeder funds" that have recently been implicated in this financial Armageddon. Even Madoff's ex-wife has been sued to recover over $2 million paid to her in their divorce settlement. European investors plan to file a class action suit to recover from the banks who marketed these fraudulent funds.

It is likely that these cases will break new legal ground regarding jurisdictional disputes, insurance, bankruptcy and international finance while trotting out the traditional concepts of breach of fiduciary duty, fraud, negligence, and civil conspiracy. With this week's testimony before Congress of whistleblower, Harry Markopolos, that he reported to an unresponsive SEC as early as 2000 that Madoff had hatched a Ponzi scheme, fingers will be pointed in every direction.

Potential Insurance Claims

Although the Madoff scheme has been called the equivalent of a "financial 9/11," insurers are not expected to take the same prominent role in the resulting litigation. Yes, both first-party and third-party insurers will be faced with coverage questions. However, there are no delusions that there is insurance coverage sufficient to satisfy the massive claims of all investors.

A recent National Law Journal article suggests that there are several avenues that investors will pursue to recover from insurers. The third-party insurance policies of financial firms, investment advisers, and auditors will likely provide fertile ground to cover liability for wrongdoing to outside parties through their directors and officers coverage, or errors and omissions coverage. Based on this, investors will likely name such intermediaries as defendants, alleging that they did not perform due diligence when they funneled money into Madoff's funds. Feeder funds - the investment advisers or auditors that helped direct money to the fraudulent funds - will also take a hit for failing to detect or disclose the fraud.

The first line of defense for these firms will be that they are victims of the fraud just like investors. On the other hand, their insurers will likely claim that the insureds are the ones who committed the fraud, invoking the policy exclusion for fraud.

The investor who dealt with small financial firms or auditors with only a few Madoff clients may be more fortunate in maximizing her recovery if the firm has significant policy coverage.

NLJ Reporter Karen Sloan further opines that "the biggest role third-party insurance may play in the legal fallout of the Madoff scandal is in covering defense costs for those firms and individuals who are sued by Madoff investors. The insurers' responsibility to pay the policyholder's legal costs depends on the terms of the insurance policy, but in some cases the defense cost is deducted from the coverage limit, further reducing the amount of money available to investors making claims."
Bilked investors may also look to first-party insurance to make up some of their losses. Homeowner's insurance policies that offer the individual investor limited coverage for securities losses due to theft may be tapped. Most of these policies limit coverage to no more than $100,000, but investors will look to these policies for a quick payout without facing competition from other investors for a piece of the pie.

Clearly, direct recovery from Madoff himself is doubtful. The liquidating trustee reported that he has found $950,000 in cash and securities in Madoff's investment firm - a pittance compared to its losses. Madoff's own insurance coverage is still in question, but again there's little hope that any possible coverage would do more than scratch the surface.

Earlier Withdrawals May be Subject to Clawback

"Clawback suits" brought by the bankruptcy trustee against investors who withdrew money prior to the collapse of the Madoff fund may likewise provide an area for recovery. The objective behind such suits is to allow these funds to be shared with victims who saw their entire investment with Madoff wiped out. For the institutional investors who did pull out some or all of their money before the scheme was exposed, a clawback suit may be covered under their own third-party liability policies.

Clawback suits will present substantial legal questions in the area of choice-of-law,

jurisdiction, and bankruptcy. One of the primary issues will be how far back the trustee may go to recover withdrawn funds. In New York, where the payments were made, the trustee can reach back up to six years. Yet the majority of states have four-year limitations periods. These disputes will also be fueled by murky bankruptcy law regarding what constitutes a "fraudulent conveyance" of payments to early investors for purposes of clawback suits.

Recovery Limited Under SIPC

Investors may also make claims for reimbursement from the federal Securities Investor Protection Corp. (SIPC) that was established to help customers of failed brokerages recover lost securities. However, questions have already arisen whether investors will be limited to claims of $100,000 in lost cash, or $500,000 for lost securities since we don't know whether Madoff actually purchased securities or simply moved cash around amongst investors. Ultimately, the SIPC may have to petition Congress for bailout money to fund the Madoff claims.

Investors who file a claim with the SIPC could unintentionally fall into legal traps affecting other aspects of their claims for recovery. For instance, such a claim could subject international investors to U.S. jurisdiction for clawback claims by the trustee. Similarly, U.S. investors may inadvertently give away details regarding withdrawals that provide a basis for clawback claims.

International Implications

The Madoff scheme spans the globe. This gives rise to even greater legal problems regarding the funds sent outside of the U.S. and the international litigation necessary to recover them. Some attorneys speculate that if assets are reigned in from European operations this will pit European investors against U.S. investors.

As further fallout, we can also expect a wave of liquidations of offshore funds that fed investor money to Madoff if they cannot satisfy investor claims.

The only certainty in the aftermath of the Madoff scandal is that the legal ramifications will be far-reaching and the legislative and regulatory efforts to prevent similar schemes will be extensive.