

## Legal Newsflash

### Topical Update from Robin Simon LLP

#### Unscrambling the Madoff mess: the legacy left for insurers

*Bernie Madoff's activities have wreaked unprecedented devastation across the financial and professional world. His mis-deeds are already reaching far beyond the investors who entrusted their money to him.*

*London partner, Jacquetta Castle, considers the legal issues raised by these events.*

On 29 June 2009 Bernard Madoff was sentenced to 150 years in prison for masterminding the largest Ponzi-scheme fraud in history which left investors across the world with approximately \$65 billion in losses<sup>1</sup>. This followed a guilty plea to 11 charges of fraud and money laundering.

As Bernard Madoff faces the rest of life in gaol, the long process of unscrambling the devastation he has caused is starting to get fully under way - recovering assets and claiming against any third parties that can conceivably take some blame.

#### THE CLAIMS

In the USA, Irving Picard has been appointed as trustee to oversee the liquidation of Madoff's broker-dealer entity, Bernard L Madoff Investment Securities LLC (BLMIS), and to deal with the claims under the Securities Investor Protection Act of 1970 (SIPA). The deadline for filing claims was extended to 2 July 2009 and a last minute rush has pushed the number of claims to over 15,000. The fact that BLMIS does not have enough assets to go around coupled with the US\$ 500,000 "per customer" limit imposed by SIPA means that most, if not all, investors will be left wanting. In the UK (where Grant Thornton has been appointed Provisional Liquidator) much of the attention is focusing on Madoff Securities International, the London business controlled and chaired by Bernie Madoff. US prosecutors are currently eyeing the London entity's £117 million of net assets.

With a shortfall on recovery inevitable, investors are seeking to recoup their losses against intermediaries and advisers. Where the investment was made via an investment management fund or with a fund of funds or feeder fund, the managers of those funds are squarely in the firing line.

Proceedings have already been brought in a numbers of jurisdictions across the world including USA, England, France, Switzerland, Spain, Luxembourg, Ireland, South America, South Africa and the Middle East together with various offshore jurisdictions.

Claims are being made against:

- Investment advisers
- Hedge funds and feeder funds
- Accountants
- Lawyers
- Auditors of hedge funds

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<sup>1</sup> Madoff's sentence truly dwarfs other US corporate sentences. Enron's Jeffrey Skilling is currently serving a 24 year sentence and Enron's Bernard Ebbers received 25 years in 2006.

- Custodians
- Fund administrators and asset managers

The claims being brought plead a variety of causes of action including fraud, negligence, negligent misrepresentation and breach of fiduciary duty.

The coverages impacted are mainly:

- E&O
- Fidelity
- D&O
- Bankers' Blanket Bond
- Excess of Loss

## LEGAL ISSUES

So far as the development of English insurance law is concerned, the litigation being generated by Madoff will raise, and indeed is raising, a number of interesting issues.

### Notification of circumstances.

Hard on the heels of the *Kidsons*<sup>2</sup> decision, claims managers are being faced with laundry list notifications from institutional investors – along the lines of “we have a client who had money in Madoff so there might be a claim”. *Kidsons* set out high level law but the claims managers in the front line are still faced with the practical issue of how to respond in any case. Insurers are entitled to reject notifications in the absence of sufficient objective justification for the view that there is a real prospect of a claim arising (depending, of course, on the precise wording in the policy). A decision has to be made in every case whether to accept the notification; reject the circumstances; reserve the position and/or send the insured back to investigate further.

### Duties owed by managers of investment funds and nature of duties owed by intermediaries.

The central question is whether a reasonably skilled investment advisor should have realised that the Madoff scheme was a fake. Madoff was, of course, a former Nasdaq Chairman at the very heart of the financial establishment where so many otherwise savvy investors, who one might think would have known better, took him on trust. He even had the US regulators fooled; the 2006 SEC investigation, launched after allegations had been made, failed to find evidence of fraud.

Courts will be scrutinizing the level of due diligence carried out. How diligently did parent companies oversee the activities of hedge funds and what duties did they have in this respect? Duties will be assessed in the light of all the circumstances including the level of sophistication of the investor, which varies widely between the institutional investors and the private individuals. Where the due diligence of intermediaries is under the microscope, the issue may turn in any case on the relationship between the intermediary and the feeder fund. There will be many other questions along the way such as the proper diversification of portfolios and selection, the role of regulators, fee disclosures, reliance on third parties and the concentration of investment functions in one place.

### Causation and reliance.

The fact also remains that investors were queuing up to join Madoff's exclusive club and it is certainly possible that whatever advice had been given, they would still have gone ahead.

### Claw-back

Some investors made a profit and those investors who redeemed early are now facing claw-back claims under the USA bankruptcy legislation for preferential and fraudulent transfers. What degree of knowledge did any investor have before withdrawing funds? To what extent is knowledge necessary? Should there be a return of principal as

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<sup>2</sup> *HLB Kidsons (a firm) v Lloyd's Underwriters (Subscribing to Lloyd's policy No. 621/PK1D00101) & Ors* [2008] EWCA Civ 1206

well as profit?

## **Damages**

The measure of damages suffered in any case will call for detailed expert evidence on the performance of the investment and the performance of alternative funds. If the investor had not entrusted his money to Madoff, how would he have invested it otherwise?

## **Legal liability and settlement.**

Some institutions have been settling early on in order to preserve reputations. The Geneva-based fund arm of Banco Santander, for example, has settled outstanding claims of over \$235 million against BLMIS. In such cases is there the required element of 'legal liability' for PI, and even more obviously D&O, coverage to be triggered? And again, what of reinsurance and follow the settlements clauses if the original settlement was voluntary?

## **Madoff exclusions.**

Some insurers are in the process of introducing or are considering introducing Madoff exclusions. Though this would seem only to affect business going forward, there is clear potential for insureds to be caught between two years. If year 1 is notified of circumstances but they are not accepted, year 2 may have a Madoff exclusion.

## **Aggregation.**

As with any fraud, there will be questions of aggregation. The House of Lords in *Lloyds TSB v Lloyds Bank Insurance*<sup>3</sup> ruled on aggregation issues in the pension mis-selling scandal. Much will depend, as it did in the *Lloyds TSB* case, on the precise wording of the aggregation clause.

## **Jurisdiction disputes and conflict of laws**

It is certainly anticipated that there will be trans-Atlantic tussles, particularly over claw-backs from non-US investors and recoveries against non-US entities.

## **Other Issues**

A host of other issues relating to insolvency, data protection, regulation and restitution are already being thrown up in the proceedings under way and no doubt this will continue.

## **THE FUTURE**

Bernie's Madoff's life expectancy has been stated to be just 13 years and it is certainly likely that while he sits out what remains of his life in gaol, stripped of his yacht, his cars and all the other trappings of his previous wealth, the legal battles will continue to reverberate for many years to come.

The legal precedents that will undoubtedly come out of these complex issues will have an important role in shaping our insurance law in the future. New laws will also be passed in an attempt to address the regulatory and corporate shortcomings that at least partly enabled Madoff to do his damage. This said, whatever steps governments and regulators take to plug the gaps, humans can be very gullible and there will always be another Bernie Madoff round the corner.

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**We can put together a seminar/talk or panel discussion on the issue above, or any of the issues featured in our publications to be held at any of our offices, or yours.**

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<sup>3</sup> *Lloyds TSB General Insurance Holdings Ltd & Ors v Lloyds Bank Group Insurance Co Ltd; Abbey National Plc v Alan Godfrey Lee & Ors* [2003] UKHL 48

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