

# Madoff Litigation: Can the Lost Billions be Recovered? How?



## Losses, Causation and Damages

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# Legal Issues Conditioning Damage Estimates



- Choice of law (Federal, state, arbitration)
- Allocation among parties (including plaintiff) based on conduct and causation
- Time at which damages are estimated (time of tort or breach, time of discovery, time of judgment)

# Private Litigation circa Jan. 9, '09



**Madoff and BMIS**

💣 By Investors: RICO, 10b-5, Section 12, Fraud, Negligent Misrepresentation, Breach of Fiduciary Duty.

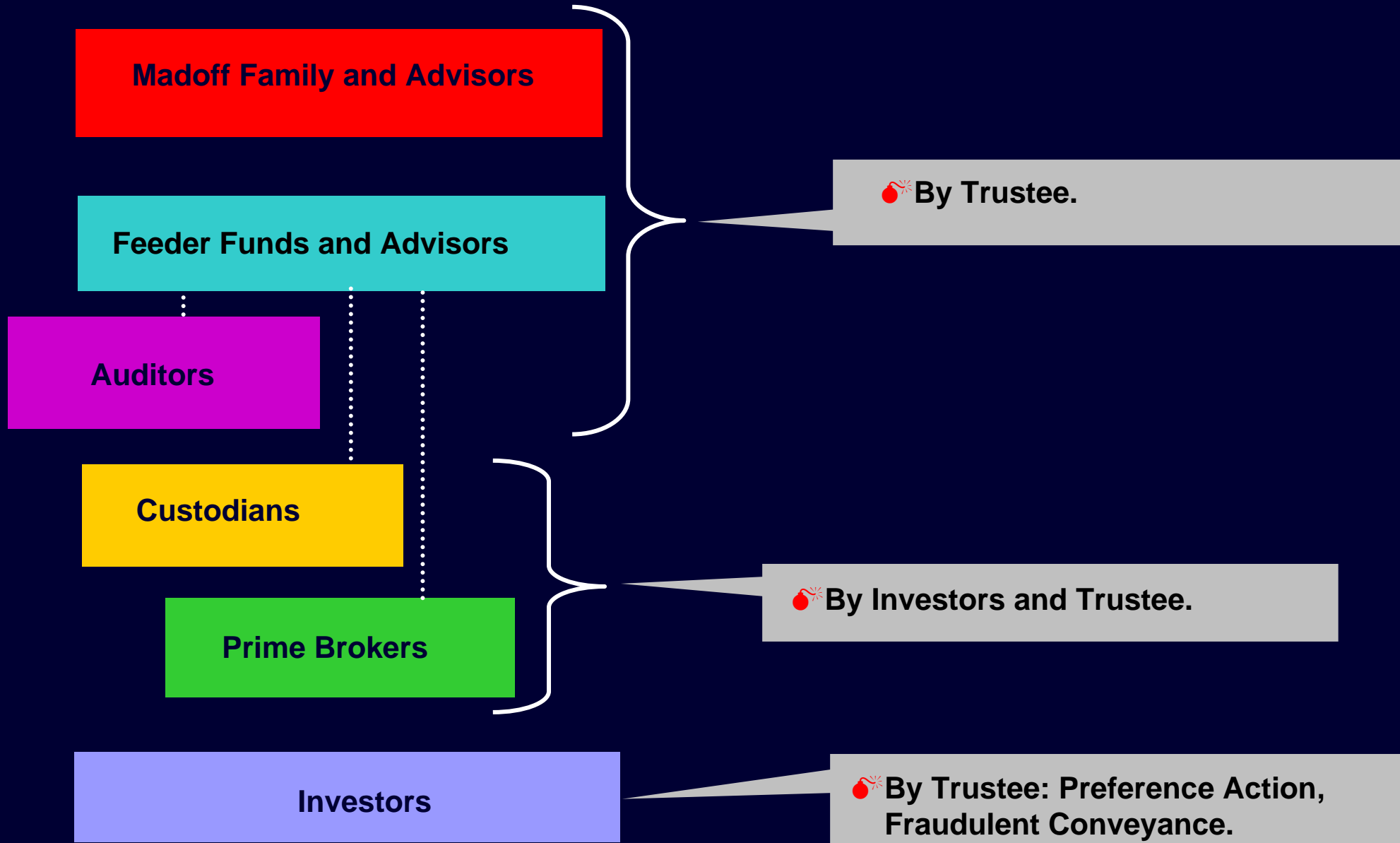
**Feeder Funds and Advisors**

💣 By Investors: 10b-5, Fraud, Negligent Misrepresentation, Breach of Fiduciary Duty, Breach of Contract, Unjust Enrichment, Derivative Claims.

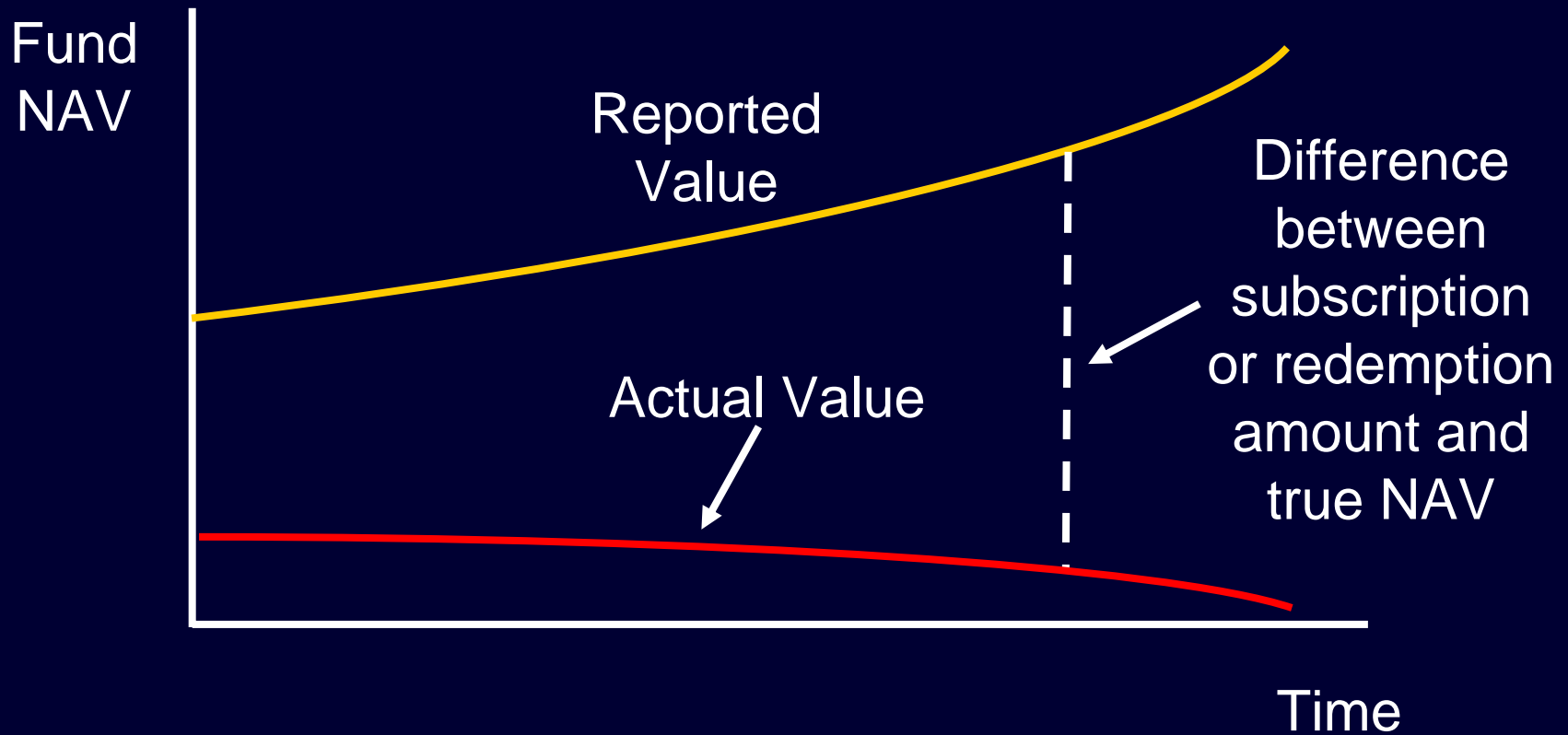
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**Auditors**

💣 By Investors: 10b-5, Fraud, Negligent Misrepresentation, Breach of Fiduciary Duty

# Possible Future Private Litigation



# Starting Point for Feeder Fund Investor 10b-5 Damage Calculations



# Starting Point for Feeder Fund Investor 10b-5 Damage Calculations



Losses Due to Fraudulent  
Reported Value

=

Loss on Subscriptions

-

Gain on Redemptions

# Losses due to Fraudulent Reporting May Be Different from Investor's Account Profit and Loss



Losses Due to Fraudulent  
Reported Value

=

Loss on Subscriptions

-

Gain on Redemptions

Investor Losses

=

Subscriptions

-

Redemptions

-

Residual Fund Recoveries

# Role of Excessive Fees in Simplified Model for Computing Damages



Investor Losses

-

Losses Due to Fraudulent Reported Value

=

Trading Losses

+

Excessive Fees

# Can Damages be Modified by Loss Causation?



- “...in connection with...” requirement for 10b-5
- Were the represented strategy followed, how would it have performed between subscriptions and withdrawals?
  - Collared S&P
  - Diversified funds

# Can Damages Be Modified by a Portfolio Damage Theory?



- “...in connection with...” requirement for 10b-5
- Were the represented strategy followed, how would it have performed between subscriptions and withdrawals?
  - Collared S&P
  - Diversified funds
- Were Plaintiff to have invested subscribed amounts differently, how would these alternative investments have performed?
  - Is Plaintiff’s non-Madoff portfolio a benchmark?

# Allocation of Damages Among Parties



- What precautions should have been taken by a sophisticated investor?

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- What duties, if any, does a feeder fund auditor have to investigate technical investment strategies of a third party?

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- What precautions should have been taken by a sophisticated investor?
- What duties, if any, does a feeder fund auditor have to investigate technical investment strategies of a third party?
- Does a feeder fund manager have a duty to the fund or to the investors?

# Conflicts between Investor and Derivative/Trustee Claims



Fraudulent Reported Value Losses to Feeder Fund or BMIS are Mirror Image of Losses to Investor

Investors

Fund

Losses Due to Fraudulent Reported Value

Losses Due to Fraudulent Reported Value

=

=

Loss on Subscriptions

Loss on Redemptions

-

-

Gain on Redemptions

Gain on Subscriptions

# SEC Rule Issued after Manhattan Fund Collapse (Dec., 2004)



- Advisers of hedge funds to register with SEC by February 2006
- Applies to the following funds:
  - Over \$25 million
  - That allow investors to redeem within two years of buying in
- Based on reading of '40 Act where fund investor is “client”
  - Overcomes 15 “client” exemption



# United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued December 9, 2005

Decided June 23, 2006

No. 04-1434

PHILLIP GOLDSTEIN, ET AL.,

PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION,

RESPONDENT

On Petition for Review of an Order of the

Securities and Exchange Commission

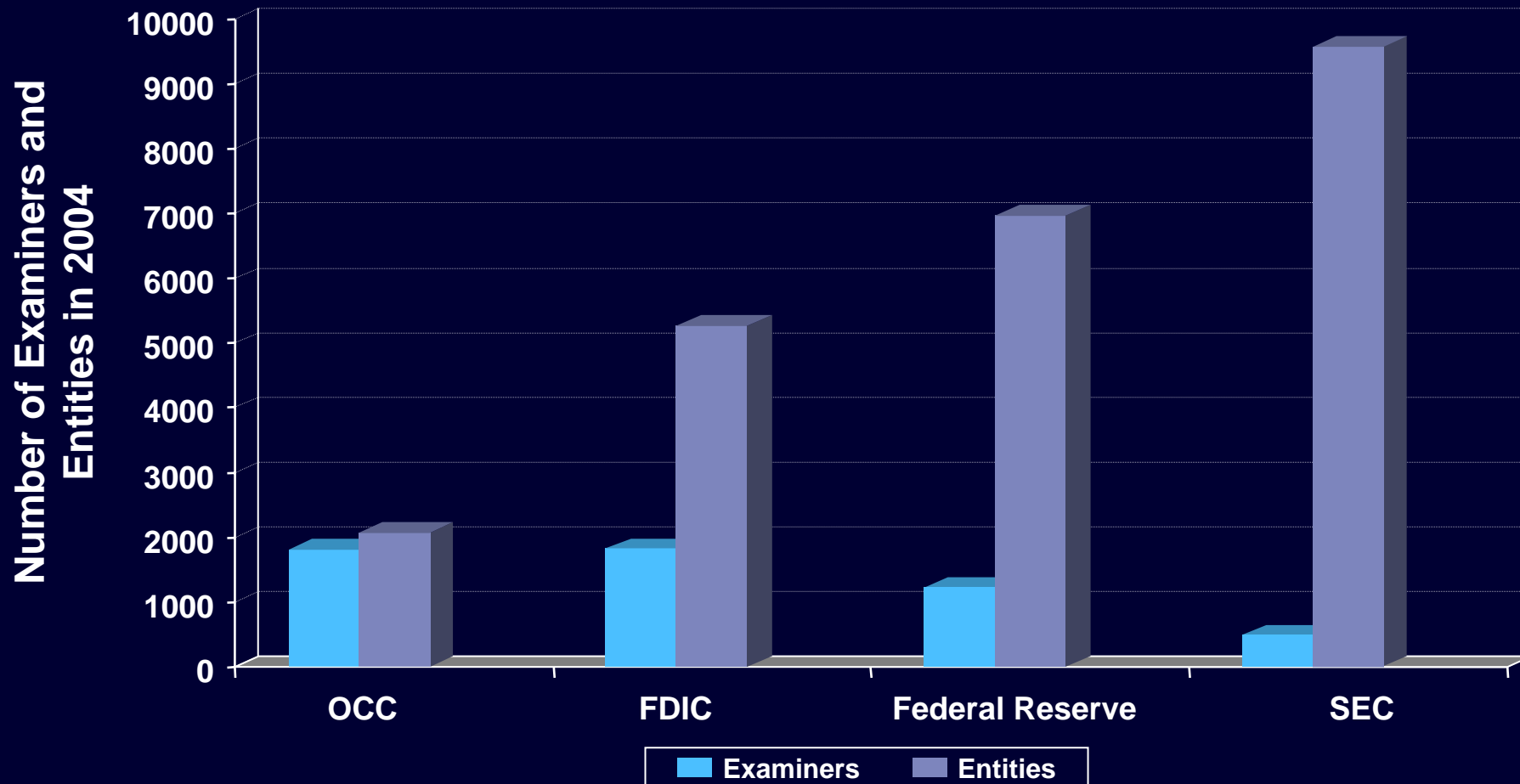
# “Client” Means Fund, Not Fund Investor *Goldstein*, p. 15



If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. ...

It simply cannot be the case that investment advisers are the servants of two masters in this way.

# The Resource Problem: Few SEC Examiners versus Many Funds



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