

September 2012

SECURITIES  
INVESTOR  
PROTECTION  
CORPORATION

Customer Outcomes  
in the Madoff  
Liquidation  
Proceeding



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Accountability \* Integrity \* Reliability

## Why GAO Did This Study

After the collapse of Bernard L. Madoff Investment Securities, LLC—a broker-dealer and investment advisory firm with thousands of individual and institutional clients—the Securities Investor Protection Corporation (SIPC), which oversees a fund providing up to \$500,000 of protection to qualifying individual customers of failed securities firms, selected a trustee to liquidate the Madoff firm and recover assets for its customers. In March 2012, GAO issued [GAO-12-414](#), which examined selection of the Trustee, his method for determining customer claims, and expenses of the liquidation, among other things. This report discusses (1) the extent to which account activity varied by type of Madoff customer, (2) the nature of claims filed, and rejected or approved, with the Trustee for reimbursement of losses, (3) litigation and settlement activity the Trustee has pursued in seeking to recover assets for distribution to customers, and (4) the effect of the fraud on customers' federal income tax liabilities. GAO reviewed transaction and claims data from the Trustee, lawsuits filed by the Trustee, IRS rules and guidance, and interviewed the Trustee, private sector tax experts, and officials from IRS, SIPC, and the Securities and Exchange Commission.

# SECURITIES INVESTOR PROTECTION CORPORATION

## Customer Outcomes in the Madoff Liquidation Proceeding

### What GAO Found

GAO's analysis of Madoff account data shows that more than three-fourths of the firm's customers were individuals and families (individuals). The remaining accounts were held by institutions, such as pension funds and charities. A higher proportion of accounts held by an individual (60 percent) were "net winners" based on their net equity position—meaning they had withdrawn more from their accounts than they had deposited—compared to accounts held by institutions (50 percent). Correspondingly, 40 percent of institutional accounts were "net losers" that had deposited more into their accounts than they had withdrawn, compared to 29 percent of individuals' accounts that were net losers. However, individual and institutional accounts had similar deposit and withdrawal activity from 1981 through 2008, including increased withdrawals immediately before the firm's failure in December 2008.

GAO's analysis shows that the Trustee's decisions to accept or reject claims were similar for individual and institutional account holders. Of the more than 16,000 claims, about 66 percent were denied because the customers were not direct account holders of the Madoff firm, but instead had invested in funds or other vehicles that held accounts directly with the firm. For the remaining claimants who were directly invested, the Trustee generally used the customers' net investment positions—that is, whether they were net winners or net losers—to determine claims. In examining claims decisions by customer type, GAO found the Trustee denied claims filed by individuals and institutions determined to be net winners in similar proportions. Similarly, most claims filed by individuals or institutions determined to be net losers were allowed.

The Trustee has been pursuing litigation to recover, or "claw back," assets from net winner customers and others that can be used to reimburse customers that did not withdraw all of their principal investments. For those customers that withdrew fictitious profits—net winners—the Trustee has been pursuing more than 1,000 lawsuits to recover funds, as allowed under federal bankruptcy law and state law. In about 60 suits, the Trustee has sought more than fictitious profits, to include principal or other funds received, arguing the parties knew or should have known of the fraud. Thus far, the Trustee said he has recovered about \$9.1 billion of the \$17.3 billion in principal investments lost by customers who filed claims, including \$8.4 billion from settlement agreements.

Because the Madoff fraud affects customers' taxable income, it also affects tax collections by the Department of the Treasury. Under Internal Revenue Service (IRS) rules, Madoff customers can deduct lost principal and fictitious profits on which they paid taxes while holding their accounts. However, IRS does not maintain statistics on specific frauds or their impacts on tax collections, and the tax impact may be reduced because some taxpayers may not be able to fully use this tax relief, such as those that lack other income that can be offset by these deductions. Tax experts expressed concerns about the lack of clarity over how payments stemming from fraud-related avoidance actions filed by the Trustee will be treated for tax purposes. In response to a recommendation in a draft report that IRS provide guidance to help limit taxpayer errors resulting in over- or underpayment of taxes, the agency issued such guidance on September 5, 2012, in the form of "frequently asked questions" posted to its website.

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### **Abbreviations**

AMT	Alternative Minimum Tax
CIO	chief information officer
CPLR	Civil Practice Law and Rules
DCL	Debtor and Creditor Law
FSM	final statement method
IRS	Internal Revenue Service
NIM	net investment method
PACER	U.S. Courts' Public Access to Court Electronic Records
SEC	Securities and Exchange Commission
SIPA	Securities Investor Protection Act of 1970
SIPC	Securities Investor Protection Corporation

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**G A O**

Accountability \* Integrity \* Reliability

**United States Government Accountability Office**  
Washington, DC 20548

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September 13, 2012

The Honorable Scott Garrett  
Chairman  
Subcommittee on Capital Markets  
and Government Sponsored Enterprises  
Committee on Financial Services  
House of Representatives

The Honorable Peter King  
House of Representatives

The Honorable Carolyn McCarthy  
House of Representatives

The Honorable Ileana Ros-Lehtinen  
House of Representatives

After the collapse of Bernard L. Madoff Investment Securities, LLC—a broker-dealer and investment advisory firm with thousands of clients—in December 2008, thousands of customers found they had lost billions of dollars to a Ponzi scheme Madoff had run for years.<sup>1</sup> Within days of the collapse, the Securities Investor Protection Corporation (SIPC), a nonprofit, nongovernmental membership corporation responsible for providing financial protection to customers of failed securities firms, designated a trustee—attorney Irving H. Picard (referred to as the Trustee throughout this report)—to oversee the liquidation of the Madoff firm and recover assets for the benefit of former customers.

The Securities Investor Protection Act of 1970 (SIPA) established procedures for liquidating failed broker-dealers. In a liquidation under SIPA, the trustee establishes a fund of customer property consisting of the cash and securities held by the broker-dealer on behalf of customers, plus any assets recovered by the trustee, for distribution among customers. The actions of the trustee in carrying out a liquidation have direct effects for former customers who lost money, such as how much of

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<sup>1</sup>A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors.

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their losses the trustee can recover. There are also indirect effects—for example, losses and potential recoveries can affect customers’ tax liabilities, which in turn affect tax collections by the U.S. Treasury.

Because the Trustee’s activities affect thousands of customers, you asked us to examine a series of questions about his efforts to resolve the Madoff liquidation. We agreed to examine these issues in two reports. The first, issued in March 2012, examined selection of the Trustee, his method for determining customer claims, and expenses of the liquidation, among other things.<sup>2</sup> This second and final report discusses (1) the extent to which account activity varied by type of Madoff customer; (2) the nature of claims filed, and rejected or approved, with the Trustee for reimbursement of losses; (3) litigation and settlement activity the Trustee has pursued in seeking to recover assets for distribution to customers; and (4) the effect of the fraud on customers’ federal income tax liabilities, including the effect on amounts that would have been due if investor losses had been based on customers’ reported final statement holdings.

For this report, we obtained and analyzed data from the Trustee, including information on deposits to and withdrawals from Madoff customer accounts from April 1981 to December 2008. We also analyzed Trustee data on claims customers made for reimbursement from proceeds of the firm’s liquidation and the determinations he reached on these claims. We examined lawsuits the Trustee has been pursuing and settlements he has reached with customers and others, including reviewing a randomly selected sample of 50 of the more than 1,000 cases filed seeking the return of fictitious profits, as allowed under federal and state law. We reviewed 29 publicly available cases from among 30 actions in which the Trustee is arguing defendants knew or should have known about the fraud, referred to as “bad faith” cases. In addition, we reviewed the largest cases among 27 actions focusing on funds that invested customer money in Madoff accounts. We interviewed the Trustee and members of his law firm, as well as SIPC executives, and officials of the Securities and Exchange Commission (SEC), which has oversight authority for SIPC. We also interviewed four individuals with income tax expertise, including a law professor and three tax advisors who we selected based on their tax experience or publications related to

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<sup>2</sup>See GAO, *Securities Investor Protection Corporation: Interim Report on the Madoff Liquidation Proceeding*, [GAO-12-414](#) (Washington, D.C.: Mar. 7, 2012).

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tax issues. We reviewed Internal Revenue Service (IRS) guidance and interviewed IRS officials about tax treatment of fraudulent schemes like the Madoff case. We conducted this performance audit from March to September 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

SIPC's mission is to promote confidence in securities markets by seeking to return customers' cash and securities when a broker-dealer fails. SIPC provides advances for these customers up to the SIPA protection limits—\$500,000 per customer, except that claims for cash are limited to \$250,000 per customer.<sup>3</sup> SIPA established a fund (SIPC fund) to pay for SIPC's operations and activities. SIPC uses the fund to make advances to satisfy customer claims for missing cash and securities, including notes, stocks, bonds, and certificates of deposit. The SIPC fund also covers the administrative expenses of a liquidation proceeding (including costs incurred by a trustee, trustee's counsel, and other advisors) when the general estate of the failed firm is insufficient.

SIPC finances the fund through annual assessments it sets for member firms, plus interest generated from its investments in Treasury notes. If the SIPC fund becomes, or appears to be, insufficient to carry out the purposes of SIPA, SIPC can borrow up to \$2.5 billion from Treasury through SEC. That is, SEC would borrow the funds from Treasury and relend them to SIPC. According to SIPC senior management, recent demands on the fund, including from the Madoff case, together with a change in SIPC bylaws that increased the target size of the fund from \$1 billion to \$2.5 billion, led SIPC to impose new industry assessments totaling about \$400 million annually. The assessments, equal to one-quarter of 1 percent of net operating revenue, will continue until the \$2.5 billion target is reached, according to SIPC senior management. The new assessments replaced a flat annual assessment of \$150 per member

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<sup>3</sup>The cash limitation amount is subject to potential adjustment for inflation every 5 years. According to SIPC, the \$500,000 limit for securities, rather than the limit for cash, applied in the Madoff liquidation. At the start of the Madoff case, the cash protection limit was \$100,000 per customer.



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firm.<sup>4</sup> Under the new levies, the average assessment for 2010 was \$91,755 per firm, with a median of \$2,095, according to SIPC.

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## Liquidations under SIPA

SIPA authorizes SIPC to begin a liquidation action by applying for a protective order from an appropriate federal district court if it determines that one of SIPC's member broker-dealers has failed or is in danger of failing to meet its obligations to customers and one or more additional statutory conditions are met.<sup>5</sup> The broker-dealer can contest the protective order application. If the court issues the order, the court appoints a trustee selected by SIPC, or, in certain cases, SIPC itself, to liquidate the firm. While SIPC designates the trustee, that person, once judicially appointed, becomes an officer of the court. As such, the trustee exercises independent judgment and does not serve as an agent of SIPC.

Under SIPA, the trustee must investigate facts and circumstances relating to the liquidation; report to the court facts indicating fraud, misconduct, mismanagement, or irregularities; and submit a final report to SIPC and others designated by the court. Also, the trustee is to periodically report to the court and SIPC on his or her progress in distributing cash and securities to customers. To the extent that it is consistent with SIPA, the proceeding is conducted pursuant to provisions of the Bankruptcy Code.

Promptly after being appointed, the trustee must publish a notice of the proceeding in one or more major newspapers, in a form and manner determined by the court. The trustee also must see that a copy of the notice is mailed to existing and recent customers listed on the broker-dealer's books and records, and provide notice to creditors in the manner

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<sup>4</sup>The Dodd-Frank Wall Street Reform and Consumer Protection Act raised the potential minimum assessment that SIPC can generally charge member firms, basing it on a percentage of gross revenues from the firm's securities business. Pub. L. No. 111-203, § 929V(a), 124 Stat. 1868 (2010).

<sup>5</sup>For SIPC to initiate a proceeding, at least one of the following other factors must exist: (1) the firm must be insolvent under the Bankruptcy Code or unable to meet its obligations as they become due; (2) the firm is subject to a court or agency proceeding in which a receiver, liquidator, or trustee has been appointed; (3) the firm is not compliant with applicable requirements under the Securities Exchange Act of 1934 or financial responsibility rules of SEC or financial self-regulatory organizations; or (4) the firm is unable to show compliance with such rules. In the smallest proceedings (in which, among other factors, the claims of all customers are less than \$250,000), SIPC may directly pay customer claims without filing an application for a protective decree with a court and without the appointment of a trustee.

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SIPA prescribes. Customers must file written statements of claims. The trustee's notice includes a claim form, and also informs customers how to file claims and explains deadlines.

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## Determination of Madoff Customer Claims

Once filed, the claims undergo various reviews, according to the Trustee. First, the Trustee's claims agent reviews claims for completeness; if information is found to be missing, the claims agent sends a request for additional information. Second, the Trustee's forensic accountants review each claim form, information from the Madoff firm's records about the account at issue, and information submitted directly by the claimant. The Trustee uses the results of this review in assessing his determination of the claim. Finally, claims move to SIPC, where a claims review specialist provides a recommendation to the Trustee on how each claim should be determined. Once that recommendation has been made, the Trustee and trustee's counsel review it, as well as legal or other issues raised previously. When the Trustee has decided on resolution of a claim, he issues a determination letter to the claimant.<sup>6</sup>

As of the start of 2012, the Trustee had received 16,519 customer claims in the Madoff proceeding, and reached determinations on all but two of them. According to SIPC, many Madoff customers were older. For example, according to Trustee information we reviewed on his hardship program (described later in this report), more than half of applicants were age 71 or older.<sup>7</sup>

In a liquidation under SIPA, amounts in the customer property fund generally are distributed to the failed firm's customers according to the value of their account holdings, or "net equity." SIPA generally provides the net equity amount is what would have been owed to the customer if the broker-dealer had liquidated all their "securities positions," less any obligations of the customer to the firm.<sup>8</sup> In the Madoff case, if the Trustee

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<sup>6</sup>The letter also informs claimants of their right to object to the determination and how to do so. The bankruptcy court judge overseeing the liquidation rules on a customer's objections after holding a hearing on the matter. Decisions of the bankruptcy court may be appealed to the appropriate federal district court, and then upward through the federal appellate process.

<sup>7</sup>This may not be representative of the entire Madoff customer population, but illustrates the age issue. Information is for individual applicants with reported ages.

<sup>8</sup>15 U.S.C. § 78III(11).

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recovers less than the total amount of allowed claims, some claimants likely will receive only a portion of their allowed claims. The Trustee told us his goal is to recover the full amount, but that is not likely, given developments in litigation and decisions to settle cases.

In SIPA liquidations not involving fraud, trustees typically determine that the amounts owed to customers match the amounts shown on their final statements, in what is known as the “final statement method” (FSM). However, in cases involving fraud, amounts in customer accounts may not correspond to statement amounts. In the Madoff case, the Trustee determined that the securities positions shown on customer statements were fictitious. As a result, supported by SIPC and SEC, he decided to value each customer’s net equity according to the amount of cash deposited less any amounts withdrawn—a method known as the “net investment method” (NIM). Under NIM, Madoff claimants generally divide into two categories: “net winners,” who have withdrawn more than the amount they invested with the Madoff firm, and “net losers,” who have withdrawn less than they invested.

Some customers challenged the Trustee’s decision on valuing customer net equity, but two courts have considered the issue—the U.S. Bankruptcy Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit—and each has affirmed the Trustee’s decision to use NIM. In June 2012, the U.S. Supreme Court declined to hear an appeal on the issue, thus concluding legal challenges to the Trustee’s decision.<sup>9</sup>

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## Efforts by the Trustee to Recover Assets for the Benefit of Customers

The Trustee has taken various steps to recover assets for distribution to former Madoff customers, including recovery of bank account balances and sale of the firm’s assets. In addition, the Trustee has filed hundreds of lawsuits known as “avoidance actions” or “clawbacks.” Avoidance powers enable a trustee to “avoid,” or set aside, certain transfers made by a debtor—here, the Madoff firm—prior to the bankruptcy filing, in order to

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<sup>9</sup>For a fuller discussion of legal issues surrounding the Trustee’s decision to use NIM, and the appeals that followed the decision, see the legal appendix in [GAO-12-414](#). For the Supreme Court’s denial, which came after our first report, see 654 F.3d 229 (2nd Cir. 2011), *cert. dismissed*, 132 S. Ct. 2712 (U.S. June 4, 2012) (No. 11-968), *cert. denied* 2012 WL 396489 (U.S. June 25, 2012) (11-969), and *cert. denied* 2012 WL 425188 (U.S. June 25, 2012) (11-986).

recover transferred funds for the benefit of the estate. In pursuing these actions, a trustee can generally seek return of fictitious profits paid to investors, and in some cases, principal amounts withdrawn, for specified periods of time—90 days, 2 years, and 6 years preceding the filing. In doing so, the Trustee has available state statutes, common law claims, and federal bankruptcy law upon which to build his cases. Actions also can vary according to whether the Trustee alleges a customer acted in good or bad faith. Under the Bankruptcy Code, a recipient’s good faith or bad faith is not relevant to whether the transfer is avoidable but does affect the extent of the recipient’s liability. Table 1 summarizes the legal avenues available. A fuller discussion of legal remedies available can be found in appendix II.

**Table 1: Legal Bases Trustee Can Use to Recover Funds from Customers and Others Involved in Ponzi Schemes**

Legal action and authority	Payments and periods covered	Potential liability	
		Good faith recipients	Bad faith recipients
Preferential transfer avoidance Bankruptcy Code § 547	Transfers 90 days prior to bankruptcy filing, except 1 year from filing for transfers to “insiders”	Principal amounts invested	Principal amounts invested
Fraudulent transfer avoidance: <i>constructive</i> fraud Bankruptcy Code § 548(a)(1)(B)	Transfers 2 years prior to filing	Fictitious profits	Fictitious profits and principal
Fraudulent transfer avoidance: <i>actual</i> fraud Bankruptcy Code § 548(a)(1)(A)	Transfers 2 years prior to filing	Fictitious profits	Fictitious profits and principal
Fraudulent transfer avoidance: <i>constructive</i> fraud Bankruptcy Code § 544(b) New York Debtor and Creditor Law (DCL) §§ 273-275 New York Civil Practice Law and Rules (CPLR) § 213(1)	Transfers 6 years prior to filing	Fictitious profits	Fictitious profits and principal
Fraudulent transfer avoidance: <i>actual</i> fraud Bankruptcy Code § 544(b) DCL § 276 CPLR §§ 203(g), 213(8)	Transfers 6 years prior to filing, or potentially earlier depending on timing of discovery of fraud	Fictitious profits	Fictitious profits and principal
Common law claims: e.g., conversion, unjust enrichment Bankruptcy Code §§ 323, 541 Common law principles as applicable	Period covered depends on nature of claim asserted	N/A	Damages, depending on nature of claim

Source: GAO summary of federal bankruptcy, New York state law.

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Generally, transfers are avoidable as actually fraudulent if the debtor-transferor had intent to defraud; or, as constructively fraudulent if they were made without fraudulent intent but for less than equivalent or fair value, while the debtor was insolvent. Courts generally presume Ponzi scheme payouts to be actually fraudulent. As for constructive fraud, Ponzi scheme transfers in excess of principal are not made for value—meaning they are not paid to satisfy any legitimate obligation the debtor owed to the recipient—and thus fall within the constructive fraud provisions.<sup>10</sup>

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<sup>10</sup>In addition to the facts of each case, actual liability will depend on legal issues such as the applicability of the “stockbroker safe harbor” (Bankruptcy Code § 546(e)), the standards used to determine good faith, and the extent of the trustee’s standing to bring common law claims.

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## Individual Customers Tended to Be Net Winners, While Transaction Patterns for Individuals and Institutions Were Generally Similar

In our analysis of information obtained from the Trustee, we identified 7,994 accounts with at least one transaction. We examined names on each of these accounts, to determine whether individuals and families (to which we refer jointly as individuals) or institutions held the accounts.<sup>11</sup> We found that individuals held more than three-fourths (77 percent) of accounts, while almost one-quarter (23 percent) of accounts were held by institutions, such as charities, pension funds, and feeder funds.<sup>12</sup> Using these groupings, we further examined the account holders' claims outcomes—whether they were net winners or net losers—and the pattern of their transactions leading up to the Madoff firm's collapse.<sup>13</sup> The Trustee, however, noted that accounts held by institutions generally represented funds from individuals as well, because with the exception of funds from nonprofit organizations, the institutions were investing money on behalf of individuals. The Trustee said that based on his examination, he was not aware of any direct corporate investment in the Madoff firm.

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## Accounts Held by Individuals Tended to Be Net Winners

As shown in table 2, our analysis indicates that a higher proportion of accounts held by individuals (60 percent) were net winners that had withdrawn more than they had deposited over the lifetime of their accounts, compared to accounts held by institutions (50 percent). We

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<sup>11</sup>We classified more than 99 percent of accounts based on account names. See appendix I for more information about our methodology and the accounts we could not classify. SEC officials told us that Madoff urged smaller investors to pool funds with others, such as friends or relatives, to increase account size. They said this may help explain the number of entities such as trusts or partnerships that were among the firm's customers. We use "family" to include family partnerships and trusts, of which there were many, according to the Trustee.

<sup>12</sup>Feeder funds are investment vehicles that collected money from investors and channeled the funds to the Madoff firm. We describe Trustee litigation against feeder funds later in this report.

<sup>13</sup>In the analysis presented in this section and elsewhere, we relied on our own examination of data provided by the Trustee. The Trustee reviewed our results, noting some small differences between our review and his work, but generally confirming our findings. Upon further review of our work, we determined that the variances arose from differing methodologies and particular algorithms used to conduct the analysis. For example, we excluded from our analysis accounts that had no transactions, and we counted multiple allowed claims for one account as a single allowed claim. Further, in determining whether accounts were net winners or net losers, we summed all applicable deposits and withdrawals to determine net positions. In a small number of cases, this produced very small negative or positive account balances, which we considered to be different than zero.

also found that more institutional accounts (40 percent) were net losers than were individual accounts (29 percent). Among individual accounts, net winners outnumbered net losers by 2-to-1, with outcomes split more evenly for institutional accounts. Overall, for both categories combined, we found that 57 percent of account holders were net winners. About one-third (32 percent) were net losers, whose total withdrawals were less than their total investment deposits. The remaining 11 percent of accounts had zero balances from a net investment perspective, with account holders having withdrawn exactly what they had invested.

**Table 2: Madoff Account Holder Types and Net Positions**

(Dollars in millions)

	Account holder type					
	Individual/family			Institution		
	Number of accounts	Percentage of all accounts of this type	Net investment position	Number of accounts	Percentage of all accounts of this type	Net investment position
Net losers	1,810	29%	\$5,135	725	40%	\$14,790
Net winners	3,667	60	(\$5,902)	910	50	(\$11,824)
Zero balance	675	11	\$0	177	10	\$0
<b>Total</b>	<b>6,152</b>	<b>100</b>	<b>(\$767)</b>	<b>1,812</b>	<b>100</b>	<b>\$2,965</b>

Source: GAO analysis of Madoff Trustee data.

Notes: Positive net investment positions represent deposits in excess of withdrawals; negative net investment positions indicate withdrawals in excess of deposits. Numbers may not sum to totals shown due to rounding.

Table 2 also shows that as a group, institutional accounts lost principal amounts they invested in the fraud, while accounts owned by individuals in the aggregate withdrew more than they invested. For individuals, the total net investment position at the time of the Madoff firm's failure was (\$767 million), meaning they had withdrawn more money than they originally invested. As a result, individual account holders as a group were net winners. By contrast, the total net investment position for institutional accounts as a group showed that they were net losers, having made nearly

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\$3.0 billion more in deposits than withdrawals.<sup>14</sup> We note that while we divided the population into account types for analytical purposes, the Trustee and SIPC executives stressed that each customer claim was determined on a case-by-case basis without regard to whether the account holder was an individual or institution.<sup>15</sup> In addition, SIPC executives noted that notwithstanding the overall totals for the two customer categories, there were nevertheless both net winners and net losers in each grouping.

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### Individual and Institutional Accounts Had Similar Patterns of Deposits and Withdrawals

Our analysis found that individual and institutional accounts had similar deposit and withdrawal activity throughout the 27-year period we examined, including during the period immediately before the failure in 2008. For both groups, total annual deposits and total annual withdrawals increased steadily since 1981, growing by greater amounts in more recent years.<sup>16</sup> Overall, deposit volume more than doubled between 2005 and 2007, rising from \$4.5 billion to \$9.4 billion annually. Withdrawal volume grew more slowly from 2005 to 2007, rising only about 14 percent, from \$5.7 billion to \$6.4 billion. However, withdrawal volume in 2008, at \$12.6 billion, was almost double the volume in 2007. Figure 1 breaks out total deposit and withdrawal activity by individual and institutional accounts. As noted, the pattern of activity is similar for each group, except that deposit volume for individual accounts was about the same in 2007 and 2008, at \$3.4 billion annually, while deposit volume from institutional accounts fell between 2007 and 2008, from \$6.0 billion to \$5.1 billion.

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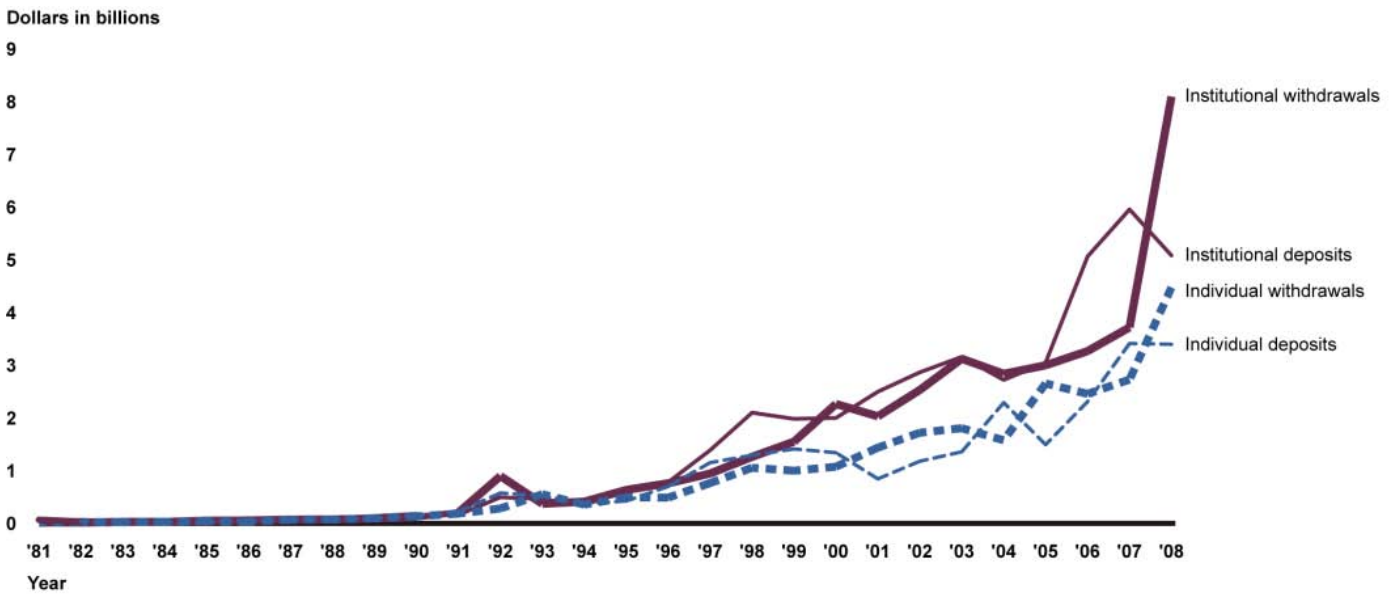
<sup>14</sup>We note the effects of one large account—Decisions, Incorporated, an institutional account used by Jeffrey Picower. As part of a settlement, the Trustee is recovering all of the about \$6.2 billion in net winnings for this account. If that account is excluded from the analysis, then the total net investment position for institutional accounts would increase from about \$3.0 billion to about \$9.1 billion. The settlement recovers a total of \$7.2 billion, covering multiple Picower accounts.

<sup>15</sup>According to SIPC executives, criteria for evaluation included whether the claimant: had an account; withdrew more than the amount deposited; and had knowledge of the fraud, or should have had knowledge of the fraud.

<sup>16</sup>We excluded one account (among the accounts owned by Norman F. Levy) from our analysis in this section because its transaction history varied significantly from other accounts. Trustee data show this account had 64,000 transactions and \$222 billion in transaction volume (the sum of deposits and withdrawals). The next largest account by volume had volume of \$9 billion. At the time of the failure, this Levy account had a net investment position of only (\$61 million), however, and a final statement amount of \$0. As discussed later in this report, the Trustee reached a settlement to recover fictitious profits.



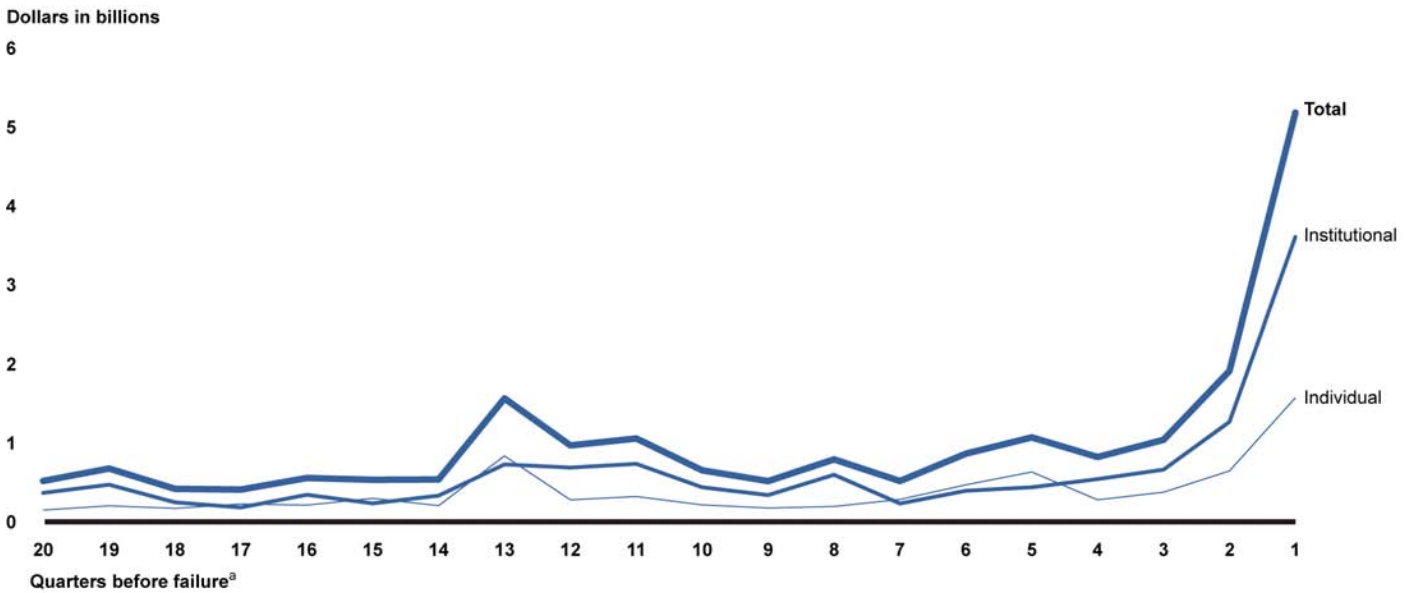
**Figure 1: Deposit and Withdrawal Activity for Madoff Customer Accounts, by Year and Account Holder Type, 1981 to 2008**



Source: GAO analysis of Trustee data.

Our analysis also showed that in the final year of the Madoff firm’s existence (2008), both individuals and institutional account holders withdrew large amounts of principal they had invested. Figure 2 shows such principal withdrawals, excluding any fictitious profits, during quarterly periods leading up to the failure. Withdrawals of principal began to increase three quarters before the failure, with most of the increase in withdrawals occurring in the 90 days before the Madoff firm’s failure. Under his clawback authority, described earlier, the Trustee can, among other things, seek to recover principal withdrawals during this period.

**Figure 2: Madoff Customers' Withdrawals of Principal, by Year and Account Holder Type, 5 Years before 2008 Failure**



Source: GAO analysis of Trustee data.

<sup>a</sup>“Quarters” refers to successive 90-day periods preceding failure.

Accounts that had large withdrawals, particularly those made just before the Madoff firm’s collapse, could suggest that such customers knew of the fraudulent scheme and were attempting to avoid suffering losses when the firm failed. Although the increase in withdrawals we identified during the period preceding collapse could suggest some customers anticipated the firm’s failure, this activity may also have been due to investor reactions to the financial crisis, which was peaking at the time, or to other factors affecting where investors place their money. As we describe later, the Trustee has filed extensive litigation to recover withdrawals that many customers made. In appendix III, we show other results of our analysis, listing the largest Madoff accounts by transaction volume, total withdrawals, and net winnings.

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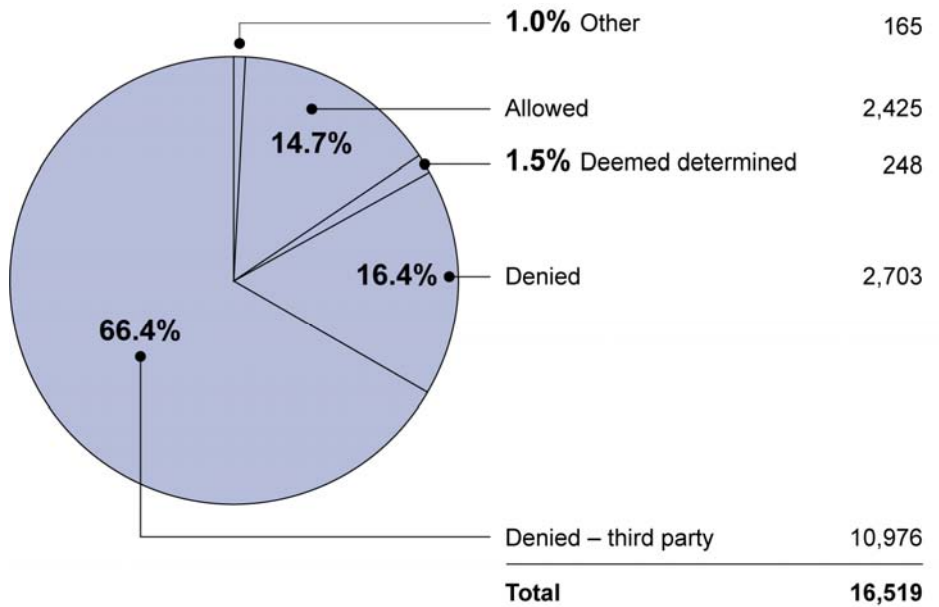
## Trustee Denied Feeder Fund Investor Claims, and Decided Individual and Institutional Claims Similarly

As required by SIPA, the Trustee solicited claims from Madoff customers for reimbursement of their losses, with approved claimants eligible to receive a share of any cash or securities Madoff held on behalf of his customers, plus assets recovered by the Trustee during the liquidation proceeding. According to claims data provided by the Trustee, a total of 16,519 claims were filed. As shown in figure 3, most of the claims were denied. Sixty-six percent of the claims were denied because the filers had not invested directly with the Madoff firm themselves (referred to as “third party” denials). Instead, they had invested in feeder funds or other vehicles that owned the accounts at the firm. The Trustee determined that under SIPA, only those who had invested directly with the Madoff firm were customers for claims purposes.<sup>17</sup>

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<sup>17</sup>The Trustee denied claims from feeder fund investors, determining that although the feeder funds themselves qualified as Madoff customers under SIPA, the feeder fund investors did not. The investors contested that determination, and in June 2010, the Trustee filed a motion with the Bankruptcy Court requesting an order upholding his denial of the investors' claims. In June 2011, the Bankruptcy Court granted the Trustee's motion, *Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*, 454 B.R. 285 (Bankr. S.D.N.Y. 2011), after which the investors appealed. In January 2012, the U.S. District Court for the Southern District of New York affirmed the Bankruptcy Court's ruling. *In re Aozora Bank Ltd.*, 2012 WL 28468 (S.D.N.Y. 2012). The case is on appeal to the U.S. Court of Appeals for the Second Circuit. SEC and SIPC supported the Trustee's determination.

**Figure 3: Trustee's Disposition of Claims Filed in Madoff Liquidation, as of April 2012**



Source: GAO analysis of Trustee data.

Notes: "Other" category consists of: claims withdrawn; claims not yet determined; and claims determined to be no claim, because they lacked necessary information or did not claim an amount. "Deemed determined" means subject to litigation with the Trustee.

Among 5,543 claims from direct investors remaining after denial of the third party claims, the Trustee denied 2,703 claims (16 percent of all claims). Almost all of the denied claims were from net winners, meaning that they had withdrawn more money than they invested. The Trustee allowed 2,425 claims (15 percent of all claims), totaling \$7.3 billion.<sup>18</sup> Of the allowed claims, the majority were filed by net losers, meaning they had withdrawn less from their account than they had invested. Figure 4 details the Trustee's disposition of claims, by net winner and loser status. However, there were exceptions to the general pattern of approvals and denials by net investment status. For example, 10 (less than 1 percent of all claims) net winner claims were allowed. According to the Trustee, in some cases, these claims were allowed because the account holders repaid certain withdrawals made from their accounts, and when they

<sup>18</sup>SIPC is paying \$889 million in advances on these claims, according to SIPC. These advances will be counted against allowed claims when claims are paid.

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returned those funds, they became eligible for an allowed claim.<sup>19</sup> In other instances, net winner claims were allowed when combined with net loser account(s) held by the same party. The Trustee also denied seven net loser claims, most often because the account was combined with net winner account(s) held by the same party.

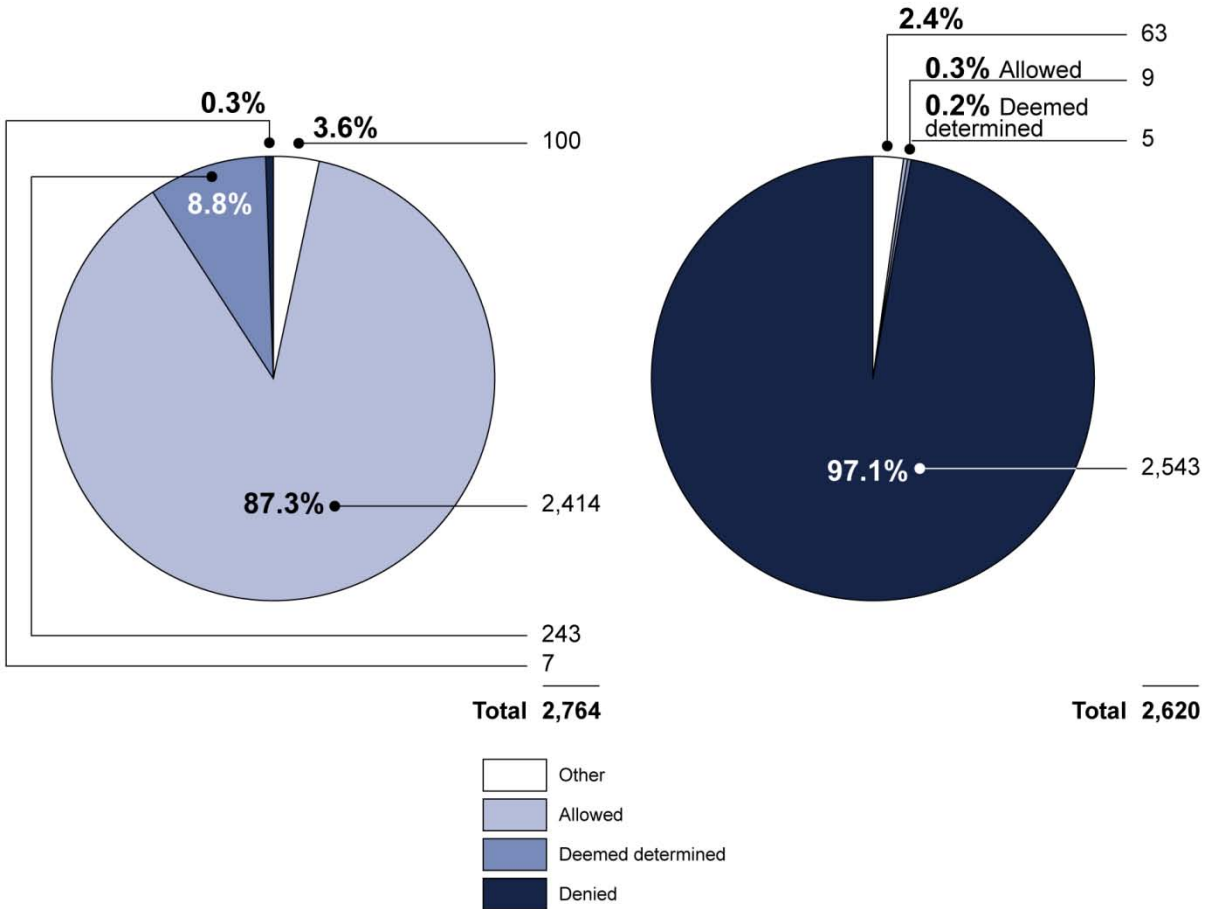
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<sup>19</sup>Under the formula the Trustee is using, claim eligibility is based on a customer's net investment (total investments less withdrawals) plus any repayments of withdrawals of principal the Trustee has obtained as part of his efforts to recover assets.

**Figure 4: Trustee’s Disposition of Claims Filed in Madoff Liquidation, by Net Loser and Net Winner Status, as of April 2012**

**Net losers**

**Net winners**



Source: GAO analysis of Trustee data.

Notes: “Other” category consists of: claims withdrawn; claims not yet determined; and claims determined to be no claim, because they lacked necessary information or did not claim an amount. “Deemed determined” means subject to litigation with the Trustee.

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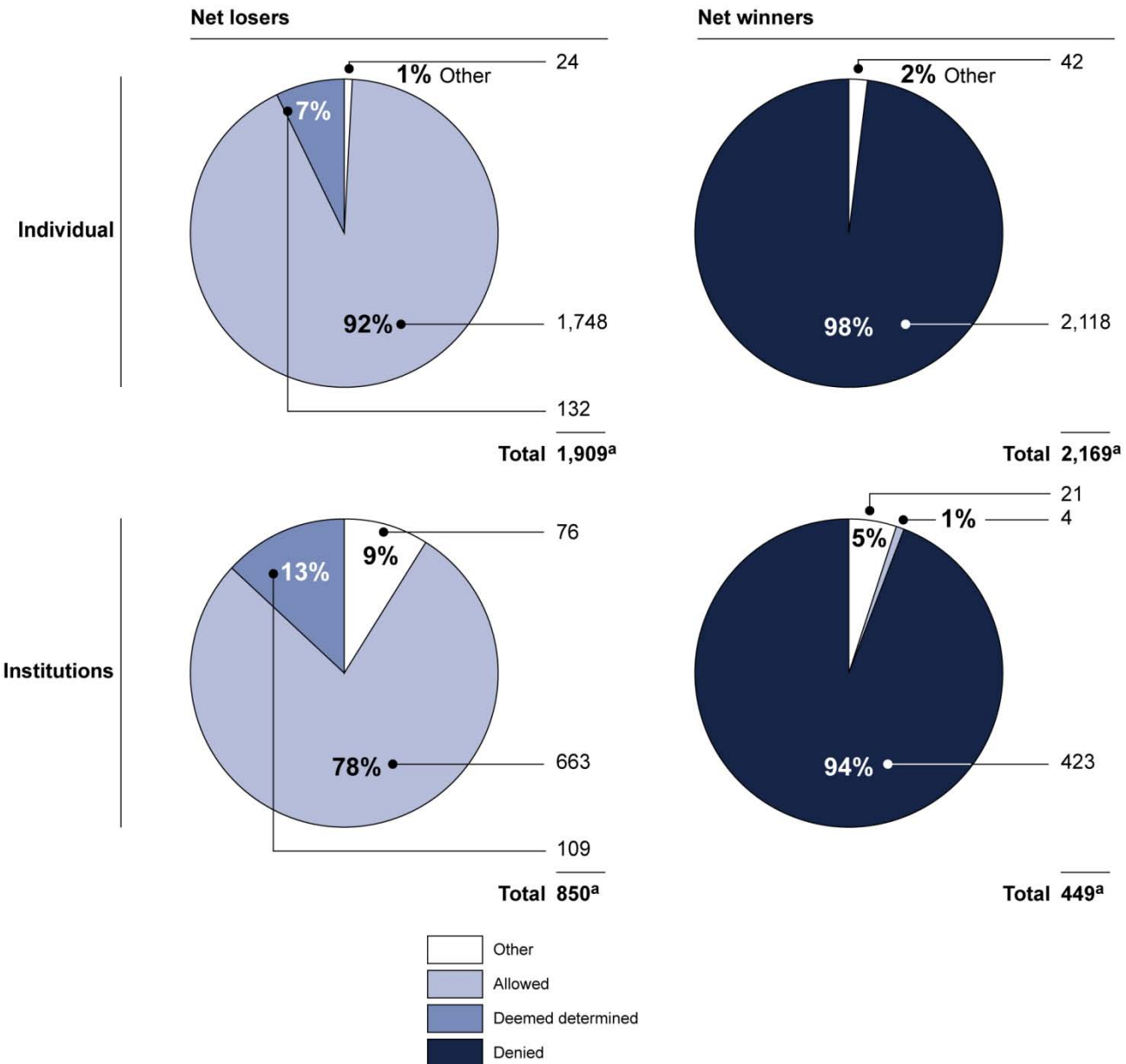
Our analysis of the Trustee's data shows that his acceptance or denial of claims was similar for both individual and institutional accounts, given account holders' net investment position.<sup>20</sup> Figure 5 shows a breakdown of claims outcomes, by account type and net investment status. As the figure shows, 98 percent and 94 percent of claims filed by individuals and institutions, respectively, who were determined to be net winners were denied—with 5 percent of the institutional net winner claims being withdrawn before final determination—so that disposition of both types was therefore almost identical. Similarly, most claims filed by individuals or institutions that were determined to be net losers were allowed or deemed determined (that is, subject to litigation with the Trustee).<sup>21</sup>

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<sup>20</sup>As SIPC executives told us, in a SIPC liquidation, each account holder with an approved claim receives the same pro-rated share of customer property, regardless of whether they are an individual or an institution. Institutions generally receive more in total payments, but only because they invested, and lost, more principal.

<sup>21</sup>SIPC executives told us they confirmed all of the Trustee's claim determinations, in order that subsequent distributions based on the claims decisions would be accurate.

**Figure 5: Trustee's Disposition of Madoff Customer Claims, by Customer Type and Net Investment Status, as of April 2012**



Source: GAO analysis of Trustee data.

<sup>a</sup>Percentages are rounded; categories with values less than 1 percent are not shown.

Notes: "Other" category consists of: claims withdrawn; claims not yet determined; and claims determined to be no claim, because they lacked necessary information or did not claim an amount. "Deemed determined" means subject to litigation with the Trustee.



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We also found that some net losers who would otherwise appear to be eligible for a claim approval did not file claims. In particular, we identified 197 net loser accounts (less than 3 percent of all accounts) that did not file. The Trustee told us such customers may not have filed claims for several reasons:

- The accounts may be owned by a person or entity that also has accounts that were larger net winners.
- The accounts may have been subject to settlements that affected claims.
- Some account holders may simply have not thought it worthwhile to file a claim.
- Some account holders thought filing a claim would call attention to themselves, which they wanted to avoid. Similarly, some foreign account holders might not have wanted their government to know they had an account in the United States for tax or other reasons, and may have believed that filing a claim would increase the likelihood that their government would find out about the account.

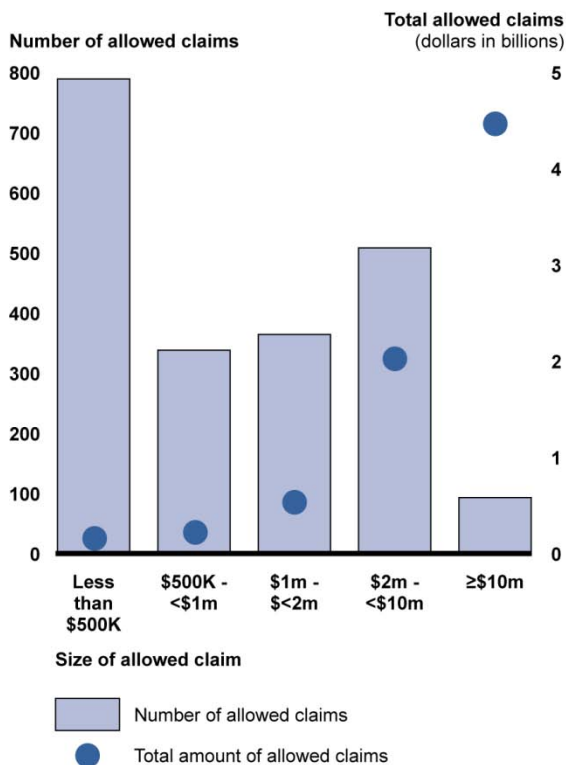
Finally, our analysis of the Trustee data shows that while most allowed claims were for less than \$1 million, a small number of large claims account for more than half of the total amount of all approved claims. As shown in figure 6, 1,127 allowed claims—each for less than \$1 million—account for 54 percent of claims allowed. The total value of these claims is about \$380 million, or about 5 percent of all allowed claim amounts. In contrast, the Trustee allowed 93 claims for \$10 million or more each. Although these claims represent about 4 percent of all allowed claims, the total value of these claims is \$4.5 billion, or 61 percent of all allowed claim amounts. The accounts with the largest allowed claims were \$1.57 billion for Optimal Multiadvisors, a Geneva-based hedge fund of Spanish banking corporation Banco Santander, and \$741 million for M-Invest Limited, a feeder fund created by Swiss bank Union Bancaire Privee.<sup>22</sup>

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<sup>22</sup>Both of these accounts were large net losers. The Optimal account related to the claim lost \$1.44 billion of principal, and M-Invest lost \$541 million of principal. The difference between the allowed claim amount and the lost principal is due to repayment of certain withdrawals through settlements, which subsequently increased the allowable claim amount. As noted earlier, the Trustee generally denied claims from feeder fund customers, but feeder funds themselves were eligible to file claims as direct Madoff investors.

The remaining allowed claims were all for less than \$300 million each. We also examined the distribution of claim size by customer type—individual and institutional accounts—and found generally similar results. Although the distributions were not identical to the overall pattern, the same results generally held for each customer type, with each group having relatively more lower-value claims and relatively fewer higher-value claims.

**Figure 6: Number and Amount of Allowed Madoff Customer Claims, as of July 2012**



Source: GAO analysis of Trustee data.

Note: Amounts shown reflect allowed claims plus amounts resulting from claims deemed determined through litigation.

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## Trustee Has Been Pursuing Hundreds of Lawsuits to Recover Assets

The Madoff Trustee is pursuing various litigation to recover assets from customers and others that can be used to reimburse those customers that have allowable claims under SIPA.<sup>23</sup> For those customers that withdrew fictitious profits in excess of their investments—net winners—the Trustee is pursuing more than a thousand lawsuits to recover these funds as allowed under federal bankruptcy law and state law. The Trustee is also suing some individuals and entities that he argues knew or should have known about the fraud and from whom he is seeking to recover more than just fictitious profits. In addition, the Trustee has filed other actions involving feeder funds. Through such efforts, the Trustee has obtained billions of dollars in settlement agreements with customers that either faced the possibility of litigation or had been sued already.<sup>24</sup> However, the Trustee established a hardship program, in which he expedited claims processing or declined to pursue litigation for individuals who could demonstrate financial distress.

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## Trustee's Authority and Approach to Litigation

As discussed earlier, various laws grant authority to the Trustee to seek return of funds paid out by the Madoff firm. This includes federal bankruptcy and state laws, which allow actions to return transfers from the failed entity—the debtor—made in different periods of time, including within 90 days, 2 years, or 6 years prior to the bankruptcy filing. In deciding whether to bring an action, the Trustee told us that he has generally considered the same factors as would apply in a typical bankruptcy case or those that a private plaintiff would also likely consider. In particular, the Trustee said he has considered the costs and benefits of taking the action—that is, how much could be recovered and at what cost—as well as prospects for success and potential legal barriers, such as the statute of limitations.

While the overall goal of an action is to recover a reasonable amount for the customer property fund, the Trustee also told us that when filing an action, he might not seek all possible assets. Many former account

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<sup>23</sup>According to the Trustee, through August 2012, \$1.1 billion had been distributed to customers, with an additional \$2.4 billion expected by September 2012.

<sup>24</sup>In addition to seeking recoveries through litigation efforts described here, the Trustee has also recovered other assets for the benefit of customers, including approximately \$500 million in bank accounts and about \$300 million in securities, he told us. The Trustee has also sold Madoff corporate assets. Thus far, the Trustee said total recoveries are about \$9.1 billion.

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holders were older and renting their homes, he said. At the same time, some customers have assets that are protected against judgments, such as homes or pension assets, which reduces the amount of assets he can pursue. The Trustee told us that while the amount of potential recoveries is important, he has not established any minimum amount in deciding whether to sue. The underlying decision on whether to sue, he said, is the acknowledgment that each time he declines to pursue an action, he allows a customer who withdrew more than their principal invested to keep money taken from others who had not recovered as much as they had invested.

According to information the Trustee provided, his litigation has targeted a high portion of amounts withdrawn from the firm during the periods preceding failure for which he is legally authorized to pursue recoveries. For example, the total amount withdrawn from the Madoff firm during the 90-day period under which federal bankruptcy law allows recoveries was \$5.5 billion, he said. Of that, his lawsuits have sought \$5.2 billion, or 95 percent. The total amount withdrawn under the 2- and 6-year recovery periods allowed by federal and state law was \$9.7 billion. Of that, the Trustee has sought \$8.4 billion, or 87 percent, he said. According to the Trustee, the differences between amounts withdrawn and sought are based on consideration of the factors whether to sue as noted earlier, as well as having reached settlements to return funds prior to filing of an action.<sup>25</sup>

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### The Trustee Has Filed Hundreds of Actions to Recover Excess Withdrawals from Customers Not Claimed to Have Known of the Fraud

According to our review, the Trustee has filed 1,002 actions seeking to recover \$3.5 billion from Madoff customers that were net winners but that are not alleged to have had knowledge of the fraud or been in a position to know about it—referred to by the Trustee as “good faith” defendants. According to the Trustee, the good faith designation indicates that while defendants profited from the fraud, he did not have evidence they had knowledge of the scheme or were in a position to know about it. When bad faith is not alleged, the laws providing the Trustee with the ability to recover funds allow him to seek principal withdrawn during the 90 days preceding the Madoff firm’s failure—the preference period—plus fictitious

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<sup>25</sup>In the descriptions of Trustee litigation that follow, we have summarized the Trustee’s complaints, but not sought to independently verify allegations or obtain the views of any defendants.

profits withdrawn in the 6 years prior to the failure.<sup>26</sup> The Trustee told us that although he anticipated negative publicity from filing suits against customers who did not know about the fraud, the \$3.5 billion at issue in the good faith cases was an amount too large to ignore.<sup>27</sup> In these good faith cases, the amounts sought by the Trustee range from a low of \$33,000 to a high of \$152 million. The average amount sought was \$3.5 million, with the median at \$1.4 million.

Some of the good faith cases have settled, but about 88 percent of complaints remained in litigation or were on appeal as of May 2012, according to information we obtained from the Trustee.<sup>28</sup> Table 3 summarizes the status of the good faith cases. In general, most good faith cases are proceeding slowly, with the Trustee seeking to mediate and settle them, he told us.

**Table 3: Status of Good Faith Litigation by Madoff Trustee, as of May 2012**

Status of case	Number of cases	Percentage of cases
In litigation	709	70.8%
Some defendants dismissed and case not dismissed	176	17.6
Other <sup>a</sup>	59	5.9
All defendants dismissed and case closed	57	5.7
In litigation/on appeal	1	0.1
<b>Total</b>	<b>1,002</b>	<b>100</b>

Source: GAO analysis of Madoff Trustee data.

<sup>a</sup>Other<sup>a</sup> is comprised of these categories: "All defendants dismissed and case not closed," "All defendants settled and dismissed and case closed," "All defendants settled but not dismissed and case not closed," and "Some defendants settled and dismissed and case not closed."

<sup>26</sup>The failure date is December 11, 2008. SIPC filed its application for liquidation on December 15, 2008, and the district court issued a protective decree that began the SIPA liquidation proceeding against Madoff and his firm.

<sup>27</sup>In some cases, the Trustee's first contact with account holders has been the filing of these complaints. This followed attempts, early on in the case, to reach out to some account holders, to learn more about their situations, the Trustee told us. However, the reaction was negative, with complaints of invasion of privacy. Thus, the Trustee said he ceased those efforts.

<sup>28</sup>The latest available data from the Trustee at the time of our review were as of May 2012.

We examined a random sample of 50 good faith cases and found them to be similarly structured and generally citing the same federal and state laws as grounds for recovery. The good faith actions generally include the name of the defendants, their account numbers, the amounts sought, and the legal basis on which the Trustee relied to seek recovery. In several filings, the Trustee also included an accounting of deposits and withdrawals. In contrast to a bad faith action, the good faith complaints we reviewed generally do not include narrative details of the defendant's history or relation to the Madoff firm. Table 4 summarizes the 10 largest actions in our sample, by amount sought.

**Table 4: Ten Largest Good Faith Complaints by Madoff Trustee among GAO Sample, by Amount Sought**

Case	Amount sought	Type of defendant(s)	Status
1096-1100 River Road Associates, LLC	\$52,907,751	Trust, individual, limited liability company	Some defendants dismissed and case not closed
The 1995 Jack Parker Descendant Trust No. 1	\$48,808,407	Trust, individual	In litigation
Robert L. Silverman	\$30,490,003	Individual, corporation, other	In litigation
RAR Entrepreneurial Fund LTD	\$17,000,000	Partnership, corporation, individual	In litigation
GMR S.A.	\$13,172,507	Corporation	In litigation
The Mosaic Fund, L.P.	\$12,696,347	Partnership, individual	In litigation
Shum Family Partnership III, LP	\$10,000,000	Partnership, corporation	In litigation
Bell Ventures Limited	\$7,400,064	Individual, other	In litigation
MBE Preferred Limited Partnership	\$4,860,000	Partnership, trust, individual, limited liability company	In litigation
Trust created under agreement 1/9/90 by Leonard Litwin	\$4,588,818	Trust, individual	In litigation

Source: GAO review of random sample of 50 Madoff Trustee case filings.

The Trustee has pursued a variety of legal approaches in the cases we sampled. Thirty-eight cases cited the 2-year period provided in the federal bankruptcy statute, while 48 cases cited the 6-year period. In six of the cases, the Trustee sought to recover transfers from the 90-day preference period. In 20 of the 50 cases, the Trustee also sued to recover funds he alleged were transferred from defendants to third parties, known as "subsequent transferees." For instance, in one case, the Trustee alleged that an individual account holder transferred to a relative some or all of \$1.2 million in fictitious profits withdrawn. Additionally, in five cases, the Trustee has also sought to temporarily disallow customer claims filed by defendants. For example, one limited liability company filed a claim for SIPC coverage in May 2009, and the Trustee filed suit to recover funds in

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December 2010. As part of the action, the Trustee sought to disallow the SIPC claim until \$4 million was recovered for the Madoff estate.

In one good faith case in our sample, the defendant was Madoff's nephew, considered an insider, and had received fraudulent transfers, but was not deemed to have acted in bad faith. Specifically, according to the Trustee, the nephew worked full-time at the Madoff firm beginning in 1980, most recently as director of administration. The Trustee alleged he received preference transfers, fictitious profits, and improperly used Madoff firm funds to pay for personal expenses. However, the Trustee told us his investigation indicated the relative was not likely aware of the fraud.

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### In Some Asset Recovery Actions, the Trustee Has Alleged That Defendants Knew or Should Have Known of the Fraud

In addition to the good faith lawsuits, the trustee has also filed 30 actions against individuals or entities in which he has alleged the defendants acted in bad faith because they either knew, or should have known, of Madoff's fraudulent investment scheme.<sup>29</sup> According to the Trustee, asserting that a defendant acted in bad faith allows him to potentially recover greater amounts than in other actions. For example, in a bad faith action, a trustee can seek to recover not only fictitious profits, but also seek principal amounts invested as well. Additionally, while New York debtor and creditor law generally limits to 6 years the period for which a trustee can seek recovery from parties that received funds from a bankrupt entity, a trustee can sue a customer that acted in bad faith in earlier years, if it can be shown the defendant knew or should have known of the fraud and certain other conditions are met. The trustee can also pursue common law claims such as conversion and unjust enrichment against bad faith defendants that received other funds from the bankrupt entity, such as receiving cash or purchases of goods on their behalf.<sup>30</sup> Common law claims allow the Trustee to seek compensatory damages to recover sums allegedly received improperly by the defendant. However, although the Trustee has the authority and standing to enforce common law claims, two recent judicial decisions dealing

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<sup>29</sup>In addition to these cases, the Trustee is also pursuing bad faith litigation involving feeder funds, which we describe later in this report.

<sup>30</sup>Common law is the body of law derived from judicial decisions, rather than from statutes or constitutions. It is sometimes also referred to as case law. Conversion is the wrongful possession or disposition of another's property. Unjust enrichment is the retention of a benefit conferred by another, without appropriate compensation.

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specifically with the Madoff liquidation limited his ability to pursue common law claims.<sup>31</sup>

Our review of the 30 bad faith actions showed that the complaints list several hundred defendants and seek \$11 billion overall, with demand amounts ranging from more than \$500,000 to approximately \$6.7 billion.<sup>32</sup> Defendants include Madoff family members, employees of the Madoff firm, individuals who identified investors for Madoff, and other business associates of Madoff. In addition to suing defendants as individuals, the complaints also seek to recover funds from vehicles these individuals used to invest in the Madoff scheme, including corporations, limited partnerships, trusts, estates, partnerships, foundations, and profit-sharing plans. Additionally, the Trustee is suing individual retirement accounts, to recover funds allegedly received from another defendant. According to the Trustee, his objective in alleging bad faith, even for some net loser defendants, is to maximize recoveries for distribution to other harmed customers.<sup>33</sup>

The Trustee has cited various factors in arguing that the defendants in the bad faith cases knew or should have known of the Madoff fraud. These factors include being an employee or officer of the Madoff firm, and acting to perpetuate the fraud or being in a position that should have allowed them to identify it. For example, among bad faith defendants is the manager of the Madoff computer system that generated falsified transactions and customer statements. The Trustee is also suing Madoff's brother, who was the firm's chief compliance officer, whose duties were to ensure the firm was complying with applicable laws. Other individuals being sued for bad faith include those who had close enough access to either Madoff or his firm that they could or should have made inquiries

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<sup>31</sup>The cases are *Picard v. JP Morgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2011), and *Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y. 2011). See appendix II for details.

<sup>32</sup>Twenty-nine of the 30 bad faith complaints are available publicly, either through the U.S. Courts' Public Access to Court Electronic Records (PACER) system or the trustee's website, <http://www.madofftrustee.com>. One bad faith complaint is under seal and unavailable. According to the trustee, this complaint involves a husband and wife as defendants and is sealed because it includes allegations about the defendants' federal income taxes.

<sup>33</sup>In addition to the bad faith actions described here, the Trustee has also filed separate bad faith actions to recover funds received by "subsequent transferees"—third parties who received funds paid to them by Madoff customers.



that could have revealed the Ponzi scheme. In some instances, the Trustee alleges that defendants were also sophisticated investors with sufficient education or specialized work experience in securities law, accounting, or finance that they should have known their returns were unusual. Table 5 shows the most frequently cited bases on which the Trustee alleged bad faith, according to our analysis of available cases.

**Table 5: Most Prevalent Bases on Which the Madoff Trustee Has Alleged Customers or Others Acted in Bad Faith**

<b>Basis for allegation defendant(s) knew or should have known of the fraud</b>	<b>Number (percentage) of bad faith cases (N=29)</b>
Defendant enjoyed unique access to Madoff firm, or had close personal relationship with Madoff.	29 (100%)
Defendant received funds or financial benefits from Madoff firm in manner that was clearly fraudulent or suspicious in nature.	24 (83%)
Defendant was Madoff employee or other associate who actively conducted or concealed fraud, or was Madoff officer who breached fiduciary duty of due diligence.	21 (72%)
Madoff accounts held by defendant experienced unusual purported transactions such as backdating or reversing or canceling of trades; or included guaranteed rates of return.	19 (66%)
Defendant was either reasonably prudent or sophisticated investor, based on education or work experience.	16 (55%)

Source: GAO analysis of bad faith complaints filed by Madoff Trustee.

Notes: A single bad faith case may cite multiple bases for acting in bad faith. Percentage figures based on 29 complaints publicly available, and excluding 1 complaint filed under seal.

The Trustee told us that initially, he believed that anyone working in Madoff's investment advisory unit would be a bad faith participant. However, through additional investigation, including document examination, taking of depositions, and reconstruction of computer records, the Trustee said he determined not all such employees may have been aware of the fraud. For example, the Trustee initially believed Madoff's secretary was involved in the fraud, given her position close to

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Madoff, but later determined she did not have knowledge of the fraudulent activities.<sup>34</sup>

In several cases, the Trustee is alleging bad faith against Madoff relatives who worked at the firm, or other, nonemployee relatives who received funds. For example, the Trustee sued Madoff's wife to recover funds transferred from the firm that were used to buy a yacht for approximately \$2.8 million, to pay off a \$1.1 million credit card balance, or to fund other investments. The Trustee sued the wife of Madoff's brother, who worked at the firm, for receiving \$1.5 million in purported salary from 1996 to 2008, after the Trustee's investigation concluded she never performed any work for the position. Among defendants who were not employees or relatives are individuals who allegedly identified and recruited investors for the Madoff firm. For example, the Trustee alleges an accounting firm pooled hundreds of millions of dollars for investment while keeping tens of millions of dollars itself.

Although many Madoff customers typically experienced outsized returns based on market developments, some bad faith defendants received exceptionally high returns, the Trustee alleges. In one case, for example, the Trustee cites returns as high as 175 percent. Moreover, in some cases, the bad faith defendants include large investors for whom the trustee alleges their financial or business sophistication provided them with the ability to realize that they were benefiting from a fraud. For example, the Trustee alleges one set of defendants is a closely held family business that was also an investor in another investment fraud that was so similar to the Madoff firm it should have been clear Madoff was also running a fraud. In his complaint, the Trustee quotes an employee of the business as saying shortly after Madoff's arrest, "Our CIO [chief information officer] always said it was a scam, 'too good to be true'[".]"

Another bad faith defendant, according to the Trustee, had been closely associated with Madoff professionally and socially for decades, investing in the firm through more than 60 entity and personal accounts. According to the Trustee, some of the accounts reported consistently high annual returns between 20 percent and 24 percent, with only 3 months of negative returns over 12 years. Other accounts of the defendant sometimes experienced returns greater than 100 percent or even 300

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<sup>34</sup>Bankruptcy Rule 2004 provides the ability to develop information through examinations, depositions, and other methods, the Trustee told us. He said he used this ability to develop information leading to good faith/bad faith determinations.

percent, he alleges. According to the Trustee, the defendant acted as an investment advisor, and thus should have known such returns were not likely possible without fraud.

As shown in table 6, the 10 largest bad faith complaints, measured by amount sought, have sought a total of \$10.7 billion, or more than 97 percent of the \$11.0 billion the Trustee is seeking in all 30 bad faith litigations. As of April 2012, the Trustee had obtained settlements, or a partial settlement, in four of these cases.

**Table 6: Ten Largest Bad Faith Complaints by Madoff Trustee, by Amount Sought**

<b>Bad faith complaint</b>	<b>Type/description</b>	<b>Amount sought</b>	<b>Amount sought as percentage of total bad faith actions</b>
Picower	Individual with long ties to Madoff.	\$6,746,066,538	61.3%
Chais	Individual with long ties to Madoff; oversaw funds invested with Madoff firm.	\$1,152,597,632	10.5%
Katz	Sophisticated investors with long ties to Madoff.	\$1,018,098,199	9.3%
Avellino & Bienes	Individuals and entities that helped perpetuate and sustain the fraud.	\$904,515,689	8.2%
Peter B. Madoff	Madoff family members, sophisticated financial professionals, and Madoff firm corporate officers.	\$226,374,622	2.1%
Cohmad Securities Inc.	Individuals and entities that helped perpetuate and sustain the fraud.	\$213,080,310	1.9%
Magnify Inc.	Individuals and entities that were sophisticated investors with unique access to Madoff that channeled money to international entities.	\$154,403,464	1.4%
Glantz	Individuals who were sophisticated investors and had long ties to Madoff.	\$113,385,537	1.0%
Blumenfeld	Individual with close ties to Madoff.	\$100,033,990	0.9%
American Securities Management LP	Sophisticated investors and entities with close ties to Madoff.	\$91,896,296	0.8%
<b>Total</b>		<b>\$10,720,452,277</b>	<b>97.4%</b>

Source: GAO analysis of Madoff Trustee data and bad faith complaints filed by the Trustee.

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## Trustee Seeking Nearly \$100 Billion in Cases Involving Entities That Channeled Investor Funds to the Madoff Firm

As noted, feeder funds are investment vehicles that collected funds from investors and then channeled the money to the Madoff firm. The Trustee has filed 27 bad faith actions against feeder fund defendants, seeking nearly \$100 billion. The amounts sought range from a low of \$10.4 million to a high of \$58.5 billion. The average amount sought is \$3.7 billion, with a median of \$182.4 million. The amounts the Trustee is seeking include fictitious profits, principal amounts invested, fees, interest, and in some cases, punitive damages. Typically, the Madoff feeder funds raised money from high-net-worth individuals in operations that spanned the globe. In addition to the feeder funds themselves, banks and other financial institutions are among the defendants in these cases. For example, some were custodians of the feeder funds, some were administrative agents, and some were involved in marketing the funds to prospective investors. Some banks and financial institutions had more than one role in their involvement with feeder funds.

According to the Trustee, feeder funds account for about \$14.2 billion of the approximately \$19.6 billion in total principal lost by all customers. In suing for bad faith, the Trustee has alleged these defendants either knew or should have known of the Madoff fraud. In some of the feeder fund cases, the Trustee is also alleging participation in, and concealment of, the fraud. With the bad faith allegations, as with bad faith cases filed against individuals, the Trustee can sue to recover funds beyond principal withdrawn in the preference period and fictitious profits withdrawn in the 6-year period. In addition, he can use common law grounds to seek additional damages based on alleged harm caused by parties aiding the fraud. As a result, the total he is seeking in the six largest feeder fund actions is \$94 billion, which greatly exceeds the amount of principal these entities invested into the scheme. Table 7 summarizes these cases, which represent nearly 95 percent of the total amount sought in feeder fund cases.

**Table 7: Key Allegations in Six Largest Feeder Fund Complaints by Madoff Trustee, by Amount Sought**

(Dollars in billions)

<b>Case</b>	<b>Total sought</b>	<b>Key Trustee allegations</b>	<b>Status</b>
Kohn	\$58.5	<ul style="list-style-type: none"> <li>Defendant, who operated as Madoff insider, knew Madoff was a fraud but fed more than \$9.1 billion to the firm over more than 20 years, often from wealthy Europeans.</li> <li>Madoff secretly paid Kohn at least \$62 million for steering funds to his firm.</li> </ul>	Some defendants dismissed and case not closed
JP Morgan Chase	\$19	<ul style="list-style-type: none"> <li>Madoff firm's primary banker for more than 20 years. Its due diligence revealed the fraud, but the bank continued business as usual.</li> <li>Defendant received at least \$500 million in fees and profits from Madoff business and also selling structured financial products tied to Madoff feeder funds.</li> </ul>	In litigation
HSBC	\$9	<ul style="list-style-type: none"> <li>Enabled the fraud by encouraging more than \$8.9 billion in investments in an international network of feeder funds through its role as marketer, custodian, and administrator of the funds.</li> <li>Defendants ignored numerous indicators of fraud and surrendered all custodial duties to the Madoff firm without any disclosure to investors.</li> <li>Aided and abetted the fraud in order to reap more than \$400 million in fees.</li> </ul>	In litigation/on appeal
Fairfield Sentry Limited	\$3.5	<ul style="list-style-type: none"> <li>Madoff firm's largest feeder fund operator, with nearly \$14 billion invested in 2008. It failed to perform due diligence after signs of fraud and misled regulators and investors.</li> <li>Defendants had actual knowledge of the fraud and received more than \$1 billion in fees.</li> </ul>	Some defendants settled but not dismissed/on appeal
Tremont Group Holdings	\$2.1	<ul style="list-style-type: none"> <li>Madoff firm's second largest feeder fund operator channeled more than \$4 billion into the fraud.</li> <li>Defendants failed to perform due diligence after signs of fraud, despite repeated warnings and opportunities.</li> <li>Defendants received more than \$240 million in fees over 15 years.</li> </ul>	Some defendants settled but not dismissed/on appeal
UBS	\$2	<ul style="list-style-type: none"> <li>UBS partnered with Access International Advisors to enable the fraud through international feeder funds.</li> <li>UBS served as custodian and administrator for the feeder funds, only to surrender all custodial duties to the Madoff firm without disclosure to investors; also relied upon the firm to verify existence of trades.</li> <li>Based on its own due diligence, UBS knew the Madoff firm was likely a fraud, but continued to do business as usual and earned at least \$80 million in fees.</li> </ul>	In litigation
<b>Total</b>	<b>\$94.1</b>		

Source: GAO review of individual case filings.

The Trustee told us that compared to other litigation he is pursuing, feeder fund actions require different types of evidence, due to the nature of their operations. For example, feeder fund managers benefited through investment and management fees charged by the funds, which were subsequently paid to individuals as salaries and bonuses. The Trustee

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considers these payments to be fraudulent. In the Tremont case, for instance, the firm managed five funds that invested directly with the Madoff firm, as well as more than a dozen other funds that were indirect Madoff investors, via investments in the directly invested funds. The Trustee alleged that in the 6 years before the Madoff firm failed, Tremont defendants received more than \$180 million in management, administration, and other fees; bonuses; profits; compensation; dividends; and partnership distributions. Additionally, a number of the feeder fund defendants were net losers. In such cases, the Trustee also sought to defer SIPA claims they filed pending resolution of the Trustee's actions against them. In general, given the complexities of feeder fund relationships, the Trustee determined amounts sought by looking at principal, not fictitious profits, he told us.<sup>35</sup>

As shown in table 7, the Trustee has alleged that banks, financial services entities, and related individuals facilitated the Madoff fraud. For example, HSBC served as marketer, custodian, and administrator for numerous feeder funds. The Trustee alleged that HSBC surrendered all custodial duties to the Madoff firm, while continuing to collect fees, and without any disclosure to investors. The Trustee stated that this surrender removed a system of checks and balances and allowed the Madoff firm to assert the existence of assets and trades that never existed. As for marketing feeder funds, the Trustee maintains that HSBC acquiesced to Madoff's demands to keep his name out of offering documents, despite the bank's own concerns about its inability to conduct proper due diligence on Greenwich Sentry, a Madoff feeder fund. Feeder funds also worked with banks to create derivative products based on feeder fund returns, according to the Trustee. For example, investors in these "leveraged notes" would be entitled to receive returns based on a feeder fund's returns, while a financial institution, usually a bank, would receive fees for structuring the notes and interest for lending funds used as part of the investment. Concurrently, the bank would purchase shares in the feeder fund in order to hedge its exposure in the leveraged notes. The end result, according to the Trustee, was that hundreds of millions of additional dollars were invested into the Madoff operation.

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<sup>35</sup>Many feeder funds themselves are in liquidation, with their own trustees, the Trustee told us. Feeder fund customers can bring a claim within their own liquidations, he said.

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In bringing the feeder fund actions, the Trustee has made a number of specific allegations to support bad faith and complaints of illicit funds received. While particular allegations vary across cases, we found the six cases we examined shared three major elements. First, defendants are alleged to have profited from the fraud primarily through fees received. For example, UBS is alleged to have received fees for purportedly serving in custodial and asset management functions for the feeder funds, Luxalpha and Groupement Financier. UBS sponsored the formation of Luxalpha and served as prime banker for Groupement Financier. The Trustee considers the fees UBS derived to be customer property that should be recovered. Second, the Trustee alleges defendants breached their duty of due diligence to their customers. For example, the Trustee alleged that Fairfield Greenwich Group, Madoff's largest feeder fund group, did not "properly, independently, and reasonably perform due diligence into the many red flags strongly indicating Madoff was a fraud." Third, the defendants are alleged to have either aided and abetted or actively participated in the fraud. In the JP Morgan Chase case, the Trustee alleged that through its interactions in different capacities—as banker, lender, and investor—with the Madoff firm over 20 years, the bank was uniquely positioned to see the fraud and put a stop to it. Instead, the trustee alleges that this institution continued to conduct business as usual, which allowed the firm to profit and the fraud to continue unabated.

As with other actions, the Trustee has sought feeder fund recoveries based on the 90-day preference period and the 2- and 6-year periods, relying on both the federal bankruptcy statute and New York state law. In instances where the defendant was considered an insider, the Trustee sought to extend the preference period to 1 year. The Trustee has also sought to recover transfers to subsequent transferees. In a number of cases, for example, the Trustee has pursued this course against individuals paid a salary or a bonus by the banks or feeder funds involved.

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### Trustee Settlements to Date Have Recovered Nearly Half of Customer Investment Losses

In hundreds of cases, the Madoff Trustee has reached settlements with former customers and others, either before or after filing clawback actions, and these agreements have produced recovery of a significant amount of assets. As of April 2012, the Trustee had entered into 441 settlement agreements in which the opposing parties agreed to return about \$8.4 billion—an amount equal to about 49 percent of the approximately \$17.3 billion in principal investments lost by customers who filed claims. According to our review, the settlement amounts range from

a low of \$36 to a high of \$5 billion, with an average of \$19 million and a median of \$66,000. Through July 2012, the Trustee had collected 85 percent of total settlement amounts, or about \$7.1 billion. Many settlement terms are complex. For example, settlements with feeder funds that were net losers require these entities to return certain funds they received before the Trustee will consider accepting their loss claims.

The Trustee groups settlements into three major categories:

- **Prelitigation:** Settlements reached before the Trustee filed a clawback action.
- **Litigation:** Settlements reached in cases where the Trustee had already filed a clawback action.
- **Customer avoidances:** Recoveries based on the 90-day preference period, but where no clawback action was filed.

A fourth category, “Funds not yet received,” is a temporary accounting of amounts that will be allocated to the three main categories upon receipt of the first settlement payment. Table 8 shows a summary of the Trustee’s settlement agreements by category as of July 2012. As the table shows, for example, the customer avoidance category represents 85 percent of all settlement agreements reached, although these cases have the smallest total dollar value among the categories. Although, as the table shows, the settlements total \$8.4 billion, the Trustee through July 2012 had yet to receive \$1.2 billion in settlement funds, due to pending appeals and specific provisions in settlement agreements.

**Table 8: Settlement Agreements Reached by Madoff Trustee, by Category, as of July 2012**

	Number	Percentage of settlements	Total settlement amount	Amount collected	Percentage collected
Customer avoidances	375	85%	\$117,173,238	\$114,642,776	97.8%
Litigation settlements	44	10	\$5,185,109,046	\$5,099,292,433	98.3
Prelitigation settlements	13	3	\$1,892,758,633	\$1,892,758,598	100
Funds not yet received <sup>a</sup>	9	2	\$1,199,150,000	N/A	N/A
<b>Total</b>	<b>441</b>	<b>100</b>	<b>\$8,394,190,917</b>	<b>\$7,106,693,807</b>	<b>84.7%</b>

Source: GAO analysis of Madoff Trustee data.

<sup>a</sup>Includes settlements of all types for which funds have yet to be received. Amounts from settlements under appeal and settlements with provisions for future payments fall into this category.



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The Trustee told us he and his counsel consider a number of factors when deciding to enter into a settlement agreement. There are no formal criteria, he said, but factors such as location of the defendants, litigation risk, and timing of the clawback can influence the settlement decision. Two of the most important factors, the Trustee told us, are the defendant's ability to pay and whether the settlement will produce proceeds that enhance the customer fund he is building during the liquidation. The bankruptcy court must approve settlement agreements worth \$20 million or more. In addition to whether a settlement is in the best interest of the estate, the court also considers whether a proposed settlement is fair and equitable, and above "the lowest point in the range of reasonableness," the Trustee told us. In deciding whether a particular agreement falls within that range, the court considers:

- probability of success in litigation;
- difficulties of collection;
- litigation complexity, and expense, inconvenience, and potential for delay; and
- creditor interests.

On the key issue of ability to pay, the Trustee said his approach is that he would rather agree to a settlement for less money and be able to collect it, than win a judgment for a greater sum that he is ultimately unable to collect. He cited the Katz-Wilpon settlement as an example.<sup>36</sup> Originally, the Trustee sued for more than \$1 billion, but reached a settlement in April 2012 for \$162 million, based on his conclusion of what the defendants could pay. In other areas, the Trustee also told us he is sensitive about clawing back funds from charitable institutions, saying that although they have received other investors' funds, he did not want to put them in the position of raising money in order to pay a settlement. We examined all but one settlement agreement among those worth at least \$20 million.<sup>37</sup> Appendix IV provides details of these settlements, including

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<sup>36</sup>Saul Katz and Fred Wilpon are co-owners of the New York Mets Major League Baseball franchise. Katz, Wilpon, members of their families, and business associates were named as defendants in the Trustee's clawback action.

<sup>37</sup>The excluded case was sealed for confidentiality, with the Trustee having filed no clawback action. Thus, details were unavailable.

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amounts sought and obtained, the extent to which settlements have been paid, strategies behind settlements, and key provisions.

A number of factors motivate counterparties to settle with him, the Trustee told us. One is that defendants have fiduciary duties to clients or customers, and amounts at issue in a case might be so significant that, for example, feeder fund managers might conclude their duty is to settle in order to recover assets for customers. Some parties, to protect client confidentiality, may settle in order to prevent disclosure of client information that could become public in litigation. Other parties might seek closure. Overall, the Trustee told us he thinks he has built a solid record in his settlements. The market itself has validated his efforts, he said, which can be seen in increases in the price of Madoff claims being traded following announcement of recent settlement agreements.<sup>38</sup>

As part of our review of records provided by the Trustee, we noted some customer accounts having a negative balance. For example, in the Picower case, the records showed a negative balance of \$6.3 billion. In theory, this reflected some kind of margin account or debit account, the Trustee told us, even though such an amount would not have been in keeping with standard industry practices. Such negative balances raised questions whether the reported amounts represented debt owed by customers to the Madoff firm, and if so, whether the presence of such debt diminished the value of settlements obtained from such customers. To obtain the \$7.2 billion Picower settlement, for example, the Trustee told us that he agreed to characterize the amount being returned as a loan repayment. However, both the Trustee and SIPC executives told us that the use of this terminology, or presence of negative balances, does not change the effect of underlying actions, which was to extract fictitious profits from the Madoff firm. In particular, the Trustee told us, he determined claims for all accounts based on the money invested less money withdrawn method. Purported indebtedness or negative balances did not affect those calculations, he said, and had no effect on settlement efforts.

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<sup>38</sup>After the Trustee made determinations on customer claims for reimbursement, a market emerged for trading of approved claims in which the right to receive the distribution of customer property from the Madoff liquidation can be sold by the claimant to other parties.

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## Under a Hardship Program, the Trustee Expedited Claims and Avoided Lawsuits for Individuals in Financial Distress

The Trustee created a hardship program in which he considered the degree of financial distress of Madoff customers in processing claims and deciding whether to pursue clawback litigation. He told us that the program was to recognize harm the Madoff fraud caused to former customers. No other SIPC liquidation has had such an option, the Trustee told us. This program, which was not open to institutional customers, had two elements for individuals who could demonstrate financial hardship:

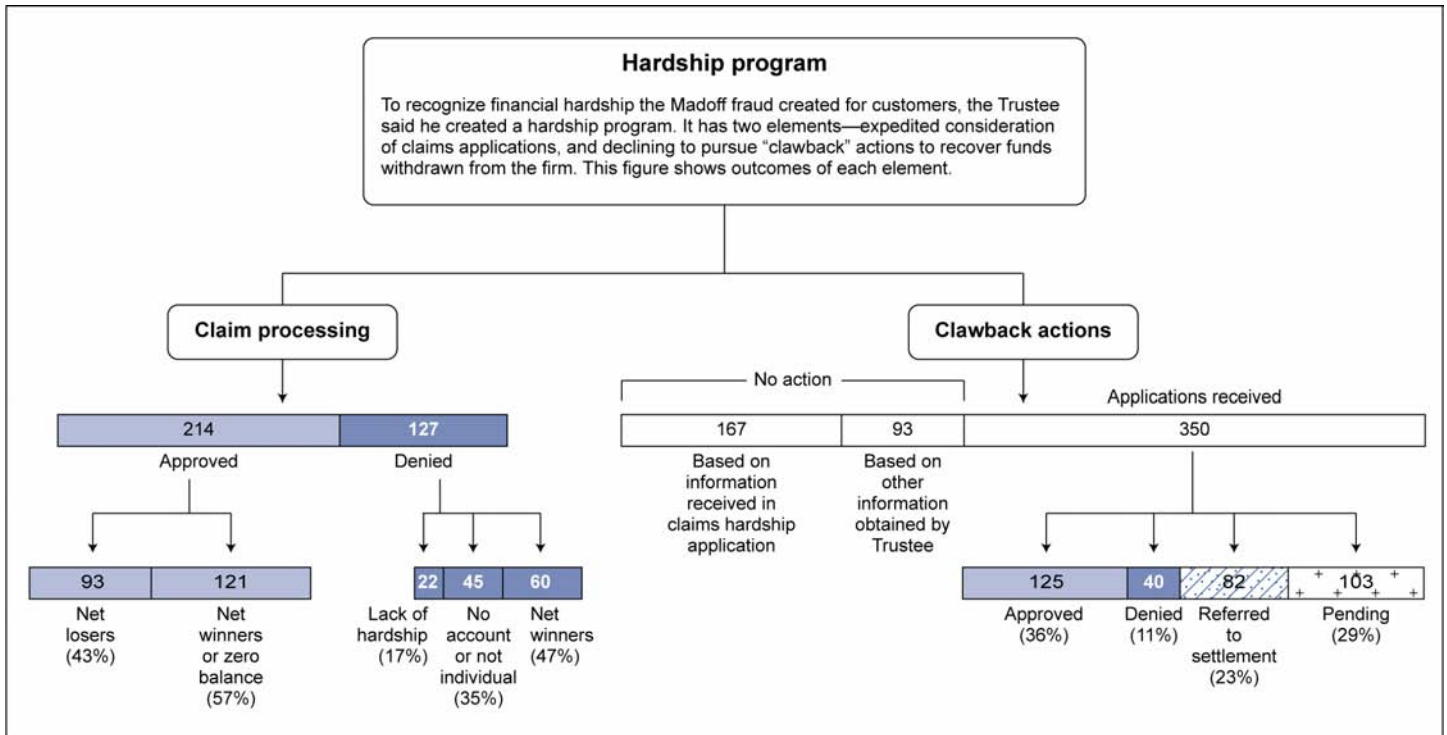
- **Claims.** The Trustee provided expedited consideration of claim applications. This did not provide applicants with any more favorable treatment, as claims were still determined on the NIM basis. But it accelerated consideration of claim applications, which, if approved, could result in customers receiving any SIPC advances due them more quickly. According to the Trustee, if complete account information was available, a determination on qualification for expedited claim review was made in about 20 to 30 days, with another 20 to 30 days to determine the actual claim. This compares to a typical claim taking 3 months or more.
- **Clawbacks.** The Trustee would not sue for clawbacks, or would drop suits already filed.<sup>39</sup>

The Trustee told us he invited applications to the hardship program, but also included some claimants in the program on his own initiative. Figure 7 shows a breakdown of the Trustee's consideration of hardship cases.

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<sup>39</sup>As noted, the hardship program was open to individuals, but the Trustee told us that in some clawback cases, a family trust might have been named in an action. In such instances, if all matters tied back to individuals, the cases could nevertheless be considered under the clawback option of the hardship program.

**Figure 7: Madoff Trustee Hardship Program Process and Outcomes, as of May 2012**



Source: GAO analysis of Trustee data.

Note: Percentages are rounded.

According to the Trustee, he assessed general factors in considering hardship applications, but there were no formal criteria or decision rules. Instead, the Trustee told us, he applied his judgment after applications were reviewed at the Trustee’s counsel law firm. The general factors, applicable to both the claims and clawback elements of the program, included whether, due to lost investments or the possibility that funds withdrawn must be returned, the customer:

- needed to return to work,
- had declared bankruptcy,
- was unable to pay for living expenses,
- was unable to pay for dependents, or
- suffered from health problems.

Additionally, the Trustee said he took into account whether former customers used any fictitious profits to pay taxes. If so, the Trustee told us he considered such payments in his decisions.

The process for considering hardship applications was similar for both the claims and clawback elements, the Trustee told us. For claims, an attorney reviewed an application and made a recommendation to the Trustee, who then decided the matter. For clawbacks, the Trustee’s counsel team responsible for the litigation reviewed the application, and, if necessary, would seek additional information. The team would make a recommendation to a review committee, comprised of five lawyers, for its evaluation. The committee would make a recommendation to the Trustee, who then decided the matter.

According to information we reviewed, hardship program applicants were predominantly older, and the most commonly cited reasons for financial distress, for either element, were the inability to pay living expenses and health problems. The Trustee said most cases were not difficult to decide, based on the evidence presented. He told us that while he and others reviewed applications carefully, requesting additional information when necessary, they attempted to not be overly intrusive into private affairs. We reviewed a number of applications provided by the Trustee, illustrating acceptance or rejection of customers’ hardship applications. Table 9 summarizes some of the cases we reviewed.

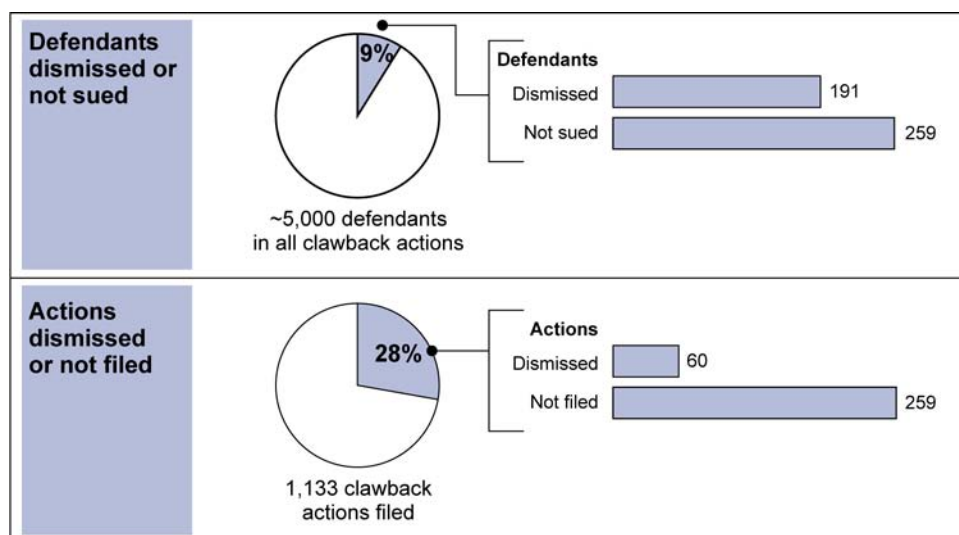
**Table 9: Examples of Customer Circumstances among Hardship Applications Accepted and Denied**

Hardship program option	Application approved	Application denied
<b>Claims</b>	Former customer said he suffered catastrophic injury, requiring multiple surgeries, forcing him out of work and jeopardizing financial stability. “I am scared of becoming homeless overnight. Please do not allow me to become...a virtual ward of the state.”	Couple with primary residence and two vacation properties said they were forced to borrow to meet annual expenses of \$450,000 plus living costs, and that SIPC payment would allow them to hold on until real estate market hopefully improved.
<b>Clawbacks</b>	Older woman said she lost husband, and his disability payments; had only Social Security income; and turned to food stamps, Medicaid, and grants from local charity. Approving hardship request “might allow me to sleep at night without the fear of being homeless.”	Older man with annual income of about \$350,000, assets of about \$7.5 million, and no liabilities said higher expected costs for medicine and care would force use of savings. “I would greatly appreciate your revoking the lawsuit that you have started against me.”

Source: GAO review of Madoff Trustee information.

As noted, the claims hardship part of the program did not alter outcomes, as it provided only expedited review. For the clawback portion, results varied by type of action, according to information the Trustee supplied in response to our queries. Figure 8 summarizes results.

**Figure 8: Results of the Clawback Element of the Madoff Trustee’s Hardship Program, as of June 2012**



Source: Madoff Trustee.

### SEC and SIPC Involved in Trustee’s Litigation and Consider It Successful Thus Far

Within weeks of the Madoff firm’s failure, SEC officials were studying whether clawback actions were permissible, and concluded they were. SEC officials told us the issue was a difficult one, because innocent investors would become the target of lawsuits; at the same time, if the Trustee did not pursue the recovery actions, others would be hurt. From the beginning of the case, SEC thought that clawbacks would produce the bulk of assets available for distribution to customers, because billions of dollars had been withdrawn from the firm shortly before its failure.

SEC officials told us they have had discussions with the Trustee (and SIPC) on his clawback litigation, on such issues as legal theories being employed, risks presented, legal costs, and expected future developments. But they have not had day-to-day involvement in the litigation, nor been involved in developing the legal strategies employed, the officials told us. SEC officials told us an examination will come later, but based on their experience, the Trustee appears to be conducting the litigation in an acceptable manner and has applied the law properly and

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fairly. They said they were not aware of any particular problems or issues with the litigation, although courts have not always adopted the Trustee's positions. SEC officials told us they were not concerned about runaway or needless litigation, and the main outcome of the litigation is that the Trustee has recovered large sums that are considerably more than initially expected.<sup>40</sup>

SIPC executives likewise told us they always thought clawbacks would be a critical part of recovering assets for customers. SIPC did not have any discussions with the Trustee about clawbacks prior to his appointment, they said, other than to discuss whether there were adequate resources available at his law firm to bring the expected cases. The officials characterized their involvement with the Trustee as providing institutional knowledge and high-level advice and strategy, albeit with the understanding that the independent Trustee need not accept it. SIPC's most significant contribution is payment of litigation expenses, SIPC executives told us, because otherwise, the Trustee could not finance his litigation. The SIPC executives told us they consider the Trustee's litigation a success, but that his efforts are thus far incomplete, as many cases remain outstanding. Although total settlement amounts to date reflect mostly one case (\$5 billion for Picower), other settlements still have produced significant sums. The cases the Trustee is pursuing are complex, involving difficult and time-consuming legal work to resolve, the executives said. Costs of the litigation are favorable when compared to what attorneys would collect in contingent lawsuits, they said.

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<sup>40</sup>SEC officials also told us that before the Trustee created the hardship program, there was significant agency concern about clawbacks, and whether the Trustee would file actions against small net winners. The specific concerns were high cost of pursuing such cases, and the relatively small amounts of money involved, the officials told us. They said they expressed these concerns to the Trustee, who thereafter created the program, which satisfactorily addressed SEC's concerns.

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## Effects of the Fraud on Income Tax Revenues Cannot Be Determined, and New Guidance on Clawbacks Could Reduce Taxpayer Errors

Because the Madoff fraud affects customers' taxable income, it also affects federal tax collections by the U.S. Treasury. Madoff customers can seek tax relief for fraud-related losses in several ways, including one special procedure announced by IRS in the wake of the firm's failure. However, IRS officials were unable to quantify the overall impact of the fraud on tax collections, and the impact may be reduced by various factors that could limit taxpayers' ability to take full advantage of the tax relief available. In addition, while the use of either NIM or FSM to determine customer net equity could lead to different outcomes for account holders, either method likely reduces tax revenues. Tax experts expressed concerns about the lack of clarity over how payments stemming from fraud-related avoidance actions, or clawbacks, filed by the Trustee will be treated for tax purposes. After we identified concerns to IRS that lack of guidance could lead to taxpayer errors resulting in over- or underpayment of taxes, the agency issued such guidance.

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## Madoff Customers Can Seek Tax Relief Several Ways

The Madoff fraud affected the federal income tax liabilities of former customers in two primary ways, according to our review.<sup>41</sup> First, customers likely paid federal income taxes on fictitious profits reported to them in each year they held their account.<sup>42</sup> Second, they likely suffered theft of funds invested, which under tax law would be considered an investment theft loss.

Typically, there are two ways to address these effects upon discovery of such fraud, according to IRS officials.<sup>43</sup> Taxpayers can file amended returns, in which they remove fictitious profits from previously reported income. In addition, they can claim a theft loss deduction against income,

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<sup>41</sup>We confine our discussion here to federal income taxes. Additional tax effects are to be expected to the extent state- or local-level income tax filings rely on or otherwise make use of federal income tax calculations.

<sup>42</sup>Ordinarily, according to IRS officials, investors must pay taxes on dividends and interest, as well as on capital gains from sales or liquidations. They do not pay taxes on unrealized capital gains. However, customer statements from the Madoff firm indicated it was regularly liquidating customer positions; thus, capital gains and losses were reported to investors as realized gains or losses. SIPC executives told us positions were reported sold monthly, as Madoff purported to move customer holdings into cash.

<sup>43</sup>We underscore these are general descriptions only. According to IRS officials and tax practitioners, individual cases can vary significantly, depending on specific taxpayer circumstances.



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to reflect principal amounts stolen and fictitious profits reflected on account statements that were not removed on any amended returns.<sup>44</sup> Under the Internal Revenue Code, an investment theft occurs when a taxpayer loses property to theft in connection with a transaction entered into for profit. Taxpayers can use amended returns or claim theft loss deductions, singly or in tandem, depending on their situation, according to IRS officials.<sup>45</sup> But each of these approaches has limitations, according to the officials. For instance, taxpayers can generally file an amended return to claim a refund of taxes paid within 3 years of the original filing date, or 2 years from the date the tax was paid, whichever is later. In the case of the theft loss deduction, taxpayers cannot take the deduction to the extent they have been reimbursed for the loss, and if they have a claim for reimbursement, they cannot deduct their loss until the amount of recovery to be received can be “ascertained with reasonable certainty.” In the Madoff case, the Trustee is working to recover assets to benefit former customers, but how much he will ultimately recover, and by when, remains unknown.

In addition to these typical remedies, IRS has also provided another option, referred to as a “safe harbor” approach. This allows taxpayers to deduct a percentage of lost principal including all previously reported profits in a single year—the year of a criminal charge against the perpetrator, or 2008 for the Madoff case.<sup>46</sup> According to IRS, the purpose of the safe harbor is to ease the compliance burden for both the agency and taxpayers, avoiding what can be complicated questions on size and timing of a theft loss deduction. Under the safe harbor approach, taxpayers can deduct 95 percent of their losses in the year of discovery

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<sup>44</sup>According to IRS, an investment theft loss deduction is allowed only to the extent an investor has not received any reimbursement for the loss.

<sup>45</sup>Generally, according to IRS officials, the ability to amend prior returns or to take a theft loss deduction does not vary by taxpayer type, such as individual or corporation. However, when an individual invests in a Ponzi scheme through another entity, such as a partnership, the rules can be different. An individual who invests in a Ponzi scheme by means of a “flow-through” entity, like a partnership or a limited liability company treated as a partnership for tax purposes, can amend returns or take a theft loss deduction, based on the proportionate share of income or deductions that flow through to partners or members of the entity. By contrast, an individual investing through a C-corporation would not be able to take a theft loss deduction, as that option would lie with the corporation itself. In general, IRS officials said, the tax code treats the partnership as an entity, but doesn’t tax at the entity level; instead, only participants are taxed.

<sup>46</sup>See Internal Revenue Service, Rev. Proc. 2009-20.

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(when the lead figure is criminally charged). The loss is calculated by adding principal invested plus profits (whether fictitious or real), less cash withdrawals and recoveries from SIPC or other sources. For taxpayers seeking recovery from third parties, such as through lawsuits, the figure is reduced to 75 percent. If the taxpayer follows the safe harbor requirements, IRS agrees not to challenge the taxpayer's treatment of a qualified loss as a theft loss, and taxpayers waive their right to other remedies that might have been available.<sup>47</sup> The safe harbor approach deems the reasonable prospect of recovery condition of the standard theft loss deduction to be satisfied in the year of discovery. Thus, Madoff customers electing to use the safe harbor approach may be able to recognize their losses earlier than under the normal method for deducting a theft loss.<sup>48</sup> However, if customers using the safe harbor approach later receive distributions of recovered assets from the Trustee that cause their claimed deduction to exceed their actual losses, they must report the excess amounts as income in the year received.<sup>49</sup>

IRS officials told us they could not say which method of claiming tax relief is best for taxpayers, because individual tax situations can vary widely.<sup>50</sup> Tax practitioners to whom we spoke said the safe harbor is attractive for its certainty and ease of use, but some taxpayers may be better off using the traditional methods. However, one practitioner told us that anyone who can use the safe harbor should do so.

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<sup>47</sup>Generally, an investor that had actual knowledge of the fraud before it became public would not be eligible to use the safe harbor, according to IRS officials. However, they could still amend returns to remove fictitious income or take a theft loss deduction, as applicable. This is because the tax code requires only that money was lost and that it was stolen from the investor. Even if an investor had knowledge of the fraud, as long as they were victims of theft, they are still eligible for amended returns or the theft loss deduction, according to the officials. However, depending on the investor's actual involvement with the fraud, IRS could deny the theft loss deduction or not allow removal of fictitious income, according to the officials.

<sup>48</sup>In addition, deductions under the safe harbor approach take into account all previously taxed income from a scheme, whether it was fictitious or real, which is more similar to the FSM method than the NIM method.

<sup>49</sup>Likewise, customers using the safe harbor approach may have an additional deduction of the remaining 5 percent or 25 percent of the loss, depending on the amount of recovered assets from the Trustee or from other claims.

<sup>50</sup>They also noted that confidentiality provisions generally bar IRS from releasing taxpayer-specific tax return information. See Internal Revenue Code, sec. 6103, "Confidentiality and disclosure of returns and return information."

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## The Fraud's Impact on Tax Collections Cannot Be Determined, but It May Be Reduced by Limits on Taxpayers' Ability to Fully Realize Tax Relief

According to IRS officials, the agency cannot determine the tax revenue loss to the U.S. Treasury that will result from Madoff customers seeking relief for their fraud-related losses. IRS cannot identify Madoff taxpayers, and even if it could, it does not collect necessary information to conduct a post-Madoff analysis of the fraud's impact on tax revenues. IRS officials told us they generally do not maintain statistics on any particular Ponzi scheme or identified investment fraud. They also told us they cannot identify which Madoff customers are using which tax relief method, further complicating any effort to assess the impact of the fraud on tax revenues.

In any case, although IRS cannot determine the amount of any revenue loss, the Madoff fraud's effect on tax collections could be reduced by various factors that can limit taxpayers' ability to take full advantage of their losses. These factors generally affect the ability of taxpayers to claim an investment theft loss deduction, rather than limit the ability to file amended returns. According to IRS officials, SIPC executives, and tax practitioners, factors affecting the ability to make use of the theft loss deduction include:

- ***Deductions need income.*** The theft loss deduction is a deduction against income, not a tax credit. Therefore, to use the deduction, taxpayers must have income to apply it against. If they do not have sufficient income, they cannot use all or part of the deduction. This could be a common situation, because many Madoff customers are older and without income. If taxpayers have insufficient income to make use of the deduction in a particular year, IRS rules allow theft loss deductions to be carried over to other years—generally, backwards for 3 years, and forward for 20. But taxpayers must still have income, and even if they do, it could take a number of years to fully apply their deductions on that income, meaning that benefits could be delayed. One tax practitioner told us that even with extended carryback and carryforward periods, he would expect many people—especially smaller investors—will not be able to use their deductions, for lack of income against which to apply it.
- ***“Leakage.”*** There can be considerable “leakage” when using the carryforward and carryback options for the theft loss deduction—that is, loss of other deductions when taking the theft loss deduction. Individuals claiming the theft loss deduction might also have other personal deductions, such as interest, taxes, or charitable contributions. With application of the theft loss carryback or carryforward amounts, income is reduced, with the result being that income against which to claim the personal deductions can be lost.

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With insufficient income against which to claim the personal deductions, they are lost as well, offsetting benefits of the theft loss deduction. This is because the personal deductions are not themselves subject to carryback or carryforward. Generalizing about the effects of leakage is difficult because such calculations are taxpayer-specific, but the effect can be substantial, according to one tax practitioner.

- **Rate differences.** A taxpayer may have initially paid taxes on fictitious profits at a relatively high marginal rate, but later realize a theft loss deduction at a lower rate. This can mean the actual value of fraud-related tax relief received is less than initial amounts of tax paid. For example, someone may have paid taxes at a 35 percent rate, but be subject to a 15 percent rate when claiming deductions, because, for example, they lost investment income or retired and their income has fallen. As a result, their deduction reduces their income by a smaller amount than the amount of taxes that they paid in the past when their income tax bracket was higher.<sup>51</sup> Such a rate difference could be significant if a taxpayer uses the IRS safe harbor approach.<sup>52</sup> A taxpayer may have received reported profits for a number of years, but be required, under the safe harbor approach, to deduct all losses in a single year. Such a large deduction in one year could reduce the taxpayer's marginal tax rate from a high rate to a low rate. For example, a taxpayer may have paid taxes at the 35 percent rate, but by taking a deduction for all losses in a single year, find their tax rate averages out significantly lower. Further, the manner in which the Alternative Minimum Tax is calculated could also cause customers to

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<sup>51</sup>In simplified numerical terms, a taxpayer who paid tax at the 35 percent rate on \$100,000 in income would pay taxes of \$35,000. But if the taxpayer later took a \$100,000 theft loss deduction, and their tax rate at the time was no longer 35 percent, but had fallen to 15 percent instead, the tax relief realized would be \$15,000—\$20,000 less than the amount of tax they initially paid. IRS officials told us that owing to individual circumstances, the reverse could also be true: A taxpayer could have paid a lower rate at the time of the fraud, and a higher rate later, making a deduction more valuable.

<sup>52</sup>The discussion here and in the “Future tax liability” item following focus on the safe harbor approach, but we note the same considerations also apply to theft loss deductions generally.

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realize the benefit of their theft loss deductions at a rate lower than when they initially paid taxes.<sup>53</sup>

- **Death.** Should Madoff customers have died, estate and trust taxation issues could prevent full utilization of tax relief arising from the Madoff losses. For example, losses can offset estate income, but any losses remaining may not transfer with the property in subsequent tax considerations, according to one tax practitioner.

In addition, other factors also stand to affect tax collections, either providing additional revenues or increasing revenue loss, according to our review. These factors include:

- **Future tax liability.** Taxpayers using the safe harbor approach may owe additional taxes in the future. By allowing taxpayers to claim 95 percent (or 75 percent) of their losses, the approach assumes a 5 percent (or 25 percent) recovery of assets by the Trustee or in other recovery proceedings. According to IRS officials, if actual recoveries exceed those amounts, taxpayers must declare the excess as income and pay taxes on that income. Currently, the Trustee expects recoveries to be at least 50 percent, meaning losses taxpayers have claimed under the safe harbor could be overstated, triggering the future tax liability.<sup>54</sup>
- **Other deductions.** Investors can generally deduct expenses incurred in the production of income, IRS officials noted. That means that over the course of the Madoff fraud, customers would have been able to reduce taxable income based on any expenses the Madoff firm charged them.
- **Madoff insiders.** The Trustee told us that payments received by Madoff insiders raise tax issues. In some cases, Madoff made loans to immediate family, other relatives, and close associates. He often

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<sup>53</sup>The Alternative Minimum Tax (AMT) is a parallel tax calculation that attempts to ensure that those benefiting from certain tax advantages still pay a minimum amount of tax. The AMT provides an alternative set of rules for calculating taxes, and if a taxpayer's tax as calculated in the normal manner falls below that amount, the taxpayer is required to make up the difference by paying the alternative minimum tax.

<sup>54</sup>IRS officials noted that the Trustee's calculation of losses for claims purposes is different from losses calculated for tax purposes, and the difference in methods could affect whether additional taxes are triggered.

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forgave such loans later, but the forgiven amounts were not reported to IRS as income, the Trustee said. In other cases, some people received large cash payments from Madoff that were not reported as income. Additionally, according to the Trustee, some insiders periodically asked Madoff to produce gains or losses on their accounts, presumably in order to offset income from non-Madoff sources for tax purposes.

- **Timing.** Even if the government surrenders tax revenue as Madoff customers realize tax relief, the U.S. government collected and had use of tax receipts for multiple years. Meanwhile, as discussed earlier, taxpayers may have difficulty making full use of available benefits today. Given time value of money, and difficulty in capitalizing on benefits, this is advantageous to the government, tax practitioners and others told us.

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### Either Claims Valuation Method Is Likely to Reduce Tax Collections

While the use of NIM or FSM to determine net equity produce different outcomes for customers, both would likely reduce tax collections for the U.S. Treasury. Under NIM, net winners generally have their claims denied and are not eligible for reimbursement from the SIPC fund. Because SIPC payments reduce the amount that a taxpayer would claim as a loss, these customers would then likely have correspondingly larger theft loss deductions. In turn, those higher deductions could cause revenue losses for the Treasury that would not have been experienced if the Trustee had used FSM, which would have provided higher SIPC reimbursements.<sup>55</sup> This can be seen in SIPC estimates for coverage under the two methods. Under NIM, SIPC estimates an outlay of \$889 million for payment of SIPC advances to Madoff customers. If FSM had been used to value claims, SIPC executives estimate that SIPC reimbursements would have increased by an additional \$1.2 billion to about \$2.1 billion. According to

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<sup>55</sup>Although SIPC, SEC, and the courts have supported the Trustee's decision to use NIM, his selection of this method remains of interest and concern to some. Thus, we discuss the tax implications of both NIM and FSM for comparison purposes only.

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IRS officials, an increase in SIPC coverage amounts—or any other coverage of losses—will correspondingly lower theft loss deductions.<sup>56</sup>

Ultimately, though, the choice of either claims determination method creates the potential for loss in tax revenues, because both NIM and FSM would create deductions against income by parties affected by the Madoff liquidation. While using FSM might have lowered theft loss deductions, owing to the greater SIPC reimbursements, it also would have caused greater demand on the SIPC fund, according to SIPC executives. As a result, SIPC's broker-dealer members would have had to pay additional amounts to keep the fund at the level targeted by the SIPC board, the executives said. These greater amounts would have been either in the form of higher member annual assessments, or maintaining SIPC's recently increased assessment for a longer period, they said. At this new assessment rate, SIPC members are currently paying about \$400 million into the fund annually.

Under SIPA, the assessments are an ordinary business expense, SIPC executives told us. Thus, they are deductible as business expenses for tax purposes by member broker-dealers, which would have the effect of lowering members' taxable income (or increasing losses). As a result, rather than the U.S. Treasury facing lower tax collections from Madoff customers due to use of NIM, it would experience lower revenues from broker-dealers under FSM. Although this tax trade-off effect is straightforward to describe, estimating how, if at all, tax revenues would change under one method compared to the other is not possible, due to taxpayer-specific reasons described earlier.

The Trustee told us that the effect on Madoff customers' tax liabilities was not a consideration in his determination of how to calculate investor net equity.<sup>57</sup> There is no statutory support for any such consideration, he said,

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<sup>56</sup>However, once a customer's SIPC payment, under either NIM or FSM, reaches the SIPC coverage limit of \$500,000 per customer, additional losses no longer have this tax effect, according to IRS officials and the trustee's counsel. That is, once the SIPC coverage limit is reached, taxpayers under either method would deduct similar amounts of losses, because there would be no additional SIPC payments to offset losses.

<sup>57</sup>As discussed earlier, the Trustee did consider the tax issue with respect to hardship cases, whereby he took into account whether customers made withdrawals in order to pay income taxes. SIPC executives and SEC officials likewise told us tax liabilities were not a factor in their considerations.

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and even if there was, considering tax implications would have created a substantial burden. To consider any tax implications, the Trustee said it would have been necessary to examine details of each account, which would have significantly increased the cost and amount of time to consider claims. Further, the Trustee told us he did not research or compile data on tax implications. However, he said he did provide information to IRS and the U.S. Department of Labor.<sup>58</sup>

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### Tax Treatment of Avoidance Actions Could Affect Accuracy of Income Tax Filings

As described earlier, a significant part of the Trustee's efforts to recover assets for distribution to Madoff customers is his avoidance action, or clawback, litigation, in which he seeks to recover funds paid to certain customers. In general, if taxpayers, due to a clawback, return money previously paid to them, they are entitled to some reduction in tax liability as a result, IRS officials told us. However, application of relevant law, which deals with issues such as timing and nature of income, can be very taxpayer-specific, they said. IRS officials also told us initially that the agency did not have generally applicable guidance on the treatment of those payments. They said the agency had been seeking to formulate the right answer for dealing with clawbacks, but that it has otherwise provided only "factually specific guidance" on a case-by-case basis. In cases in which IRS has not issued such specific guidance, taxpayers must rely on the Internal Revenue Code, regulations, court cases, and relevant revenue rulings by the agency. Tax practitioners to whom we spoke noted uncertainties in determining how clawbacks should be treated for tax purposes, and that this makes completing income tax returns challenging and could contribute to errors.

IRS officials to whom we spoke said they had not issued guidance on this topic because their general approach was to initially focus on issuing guidance in areas with more widespread effect, such as the safe harbor procedures. A part of IRS's mission is to help taxpayers understand and meet their tax responsibilities, and more than a thousand Madoff account holders and others face the possibility of having to return funds to the Trustee as a result of clawbacks. Future financial fraud cases could involve clawbacks in their resolutions as well. Without additional guidance

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<sup>58</sup>According to the Trustee, IRS was interested in the NIM calculation of net equity; the length of time customer accounts were open, perhaps to assess the impact of potential tax benefits; and information on types of customer accounts, such as individuals, corporations, or nonprofits. The Department of Labor received account information.



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to taxpayers for such situations, the potential for taxpayer error is increased, which could lead to either over- or underpayment of taxes to the U.S. Treasury. A recent audit by the Department of the Treasury Inspector General for Tax Administration illustrated tax compliance issues surrounding investment theft losses. After reviewing what it said was a statistically valid sample of 140 returns claiming investment theft loss deductions for 2008, the inspector general's audit estimated that 82 percent of 2,177 tax returns may have erroneously claimed deductions totaling more than \$697 million and resulting in revenue losses of approximately \$41 million. Three percent of the tax returns the inspector general sampled included taxpayers who claimed more than \$215,000 in investment theft losses resulting from the Madoff scheme.<sup>59</sup> This audit did not specifically investigate treatment of clawbacks.

Given the number of taxpayers that could be affected by clawbacks, in the Madoff case or others, the lack of guidance could affect the accuracy of many tax returns and potentially involve billions of dollars in returned funds. We identified this concern to IRS and recommended in a draft report that the Commissioner of Internal Revenue ensure that the agency provide taxpayer guidance on a timely basis on the proper tax treatment of funds returned through avoidance actions or settlements arising from cases of investment fraud. Subsequently, IRS on September 5, 2012, issued such guidance, in the form of "frequently asked questions" on how to treat clawbacks, which were posted to the agency's website.<sup>60</sup>

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<sup>59</sup>See Treasury Inspector General for Tax Administration, *Many Investment Theft Loss Deductions Appear to be Erroneous*, 2011-40-124, September 27, 2011.

<sup>60</sup>Given the timing of IRS's release of the guidance, we had insufficient time to evaluate its content. See the guidance at <http://www.irs.gov/uac/FAQs-Related-to-Ponzi-Scenarios-for-Clawback-Treatment>.

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## Agency and Third Party Comments and Our Evaluation

We provided a draft of this report to SEC, SIPC, IRS, and the Trustee for their review and comment, and each provided technical comments, which we have incorporated as appropriate.

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We are sending copies of this report to the appropriate congressional committees, the SEC Chairman, the SIPC President, the Commissioner of Internal Revenue, and the Trustee for the Madoff liquidation. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>. If you or your staff have any questions regarding this report, please contact me at (202)-512-8678 or [clowersa@gao.gov](mailto:clowersa@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



A. Nicole Clowers  
Director  
Financial Markets and  
Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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This report discusses (1) the extent to which account activity varied by type of customer of the failed Bernard L. Madoff Investment Securities, LLC firm; (2) the nature of claims filed, and rejected or approved, with the Trustee for reimbursement of losses following the firm's failure due to fraud; (3) litigation and settlement activity the Trustee has pursued during the subsequent liquidation of the firm, in seeking to recover assets for distribution to customers; and (4) the effect of the Madoff fraud on customers' federal income tax liabilities, including the effect on amounts that would have been due if investor losses had been based on customers' reported final statement holdings.<sup>1</sup>

To examine the extent to which account activity varied by Madoff customer type, we obtained data files from the Madoff Trustee containing account holder names and transaction activity, including deposits and withdrawals from April 1981 to December 2008. We calculated customers' net investment status—whether accounts were “net winners,” in which customers withdrew more than they had deposited, or “net losers,” in which they deposited more than they withdrew—by summing transactions for each account.<sup>2</sup> Because customer statements are not available for earlier dates, the transactions data provided by the Trustee contains only transactions on or after April 1, 1981. For accounts opened before April 1, 1981, the data lists a deposit for amounts shown on customer statements as of April 1, 1981, and we considered these entries as deposits for our analysis as well. These deposits totaled about 0.18% of all deposits. Based on account names, we classified account holders as either individual or family—which we jointly considered as individual—or institutional, such as charities, pension funds, or investment vehicles known as “feeder funds” that collected funds from individual investors for deposit with the Madoff firm. Using the account names, we classified as individual or institutional more than 99.6 percent of 7,994 accounts we

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<sup>1</sup>The Trustee in the Madoff liquidation is Irving H. Picard; the trustee's counsel is the law firm of Baker & Hostetler LLP, of which the Trustee is a member.

<sup>2</sup>We excluded from our analysis transactions we identified as instances of the Madoff firm debiting foreign account holders for purported U.S. federal income tax withholding and paying those amounts to the Internal Revenue Service (IRS). These amounts, totaling about \$330 million, were later credited to the accounts through a December 2011 settlement between the Trustee and IRS.

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identified with at least one transaction.<sup>3</sup> We could not classify 30 accounts because the account holder names did not provide sufficient information to make a determination. These 30 accounts had a total of \$82 million in deposits and \$117 million in withdrawals, each of which is less than 0.1 percent of all deposits and withdrawals. Using the account classifications and net investment status, we analyzed subgroups of the overall customer population, to examine potential differences in account activity. Specifically, we reviewed deposits, withdrawals, and timing of these transactions. In reviewing withdrawals, we also focused specifically on withdrawal of principal amounts, as distinct from fictitious profits. This is because under his authority to sue for return of assets, the Trustee can, among other things, presumptively seek to recover principal withdrawals during the 90-day period immediately before the Madoff firm failed. In our analysis, we relied on our own examination of data provided by the Trustee. The Trustee reviewed our results, noting some small differences between our review and his work, but generally confirming our findings. Upon further review of our work, we determined that the variances arose from differing methodologies and particular algorithms used to conduct the analysis. For example, we excluded from our analysis accounts that had no transactions, and we counted multiple allowed claims for one account as a single allowed claim. Further, in determining whether accounts were net winners or net losers, we summed all applicable deposits and withdrawals to determine net positions. In a small number of cases, this produced very small negative or positive account balances, which we considered to be different than zero. We also interviewed the Trustee and members of his law firm on customer-type and transaction-related issues. To assess the reliability of the account and transaction data provided by the Trustee, we interviewed members of the trustee's counsel law firm and a contractor that manages the data, reviewed reports of the forensic accountants that assembled the data from records of the Madoff firm, and examined the data for invalid or missing data points. We concluded the data were sufficiently reliable for our purposes.

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<sup>3</sup>Specifically, we used a computer program to classify accounts based on keywords we identified that were associated with particular types of accounts, such as "JT" (an abbreviation of "joint trust," which indicates an individual or family account) or "pension" (denoting a pension plan, which indicates a institutional account). We reviewed the automatically classified accounts to identify cases for which the classification was not appropriate. For other accounts not containing the keywords we identified, we classified them by type in two independent examinations, and then reconciled any differences between the two reviews.

To examine the nature of claims filed and then rejected or approved following the Madoff firm's failure, we obtained claims data from the Trustee. We tallied claims received and claims dispositions, while also examining the total claims population, and claims outcomes. We matched claims information with account information as described above to examine claim information by customer type and net investment status. As described above, we relied on our own examination of data provided by the Trustee. We also interviewed the Trustee and members of his law firm on claims-related issues. To assess the reliability of claims data provided by the Trustee, we interviewed members of the trustee's counsel law firm and a contractor that manages the data and examined the data for invalid or missing data points. We concluded the data were sufficiently reliable for our purposes.

To examine litigation and settlement activity the Trustee has pursued during liquidation of the Madoff firm, we obtained and analyzed court documents covering a range of legal activity. These included: lawsuits against net winners that are not alleged to have had knowledge of the fraud or been in a position to know about it—referred to by the Trustee as “good faith” defendants; lawsuits against individuals and entities the Trustee argues knew or should have known about the fraud—referred to by the Trustee as “bad faith” defendants; lawsuits against investment vehicles that collected funds from investors and invested them with the Madoff firm; and agreements the Trustee has reached to settle a number of the actions he has filed as part of his asset recovery efforts. We selected a random sample of 50 good faith actions for examination, from among more than 1,000 cases filed; we reviewed 29 publicly available bad faith complaints from among 30 such actions filed, analyzing the most frequently cited bases for the Trustee's allegations of bad faith; we examined the largest complaints among 27 actions filed against feeder funds; and we reviewed the largest settlements the Trustee had reached during his litigation efforts. In addition, we examined Trustee records associated with the “hardship program,” in which the Trustee expedited claims processing or declined to pursue litigation for customers that could demonstrate financial distress. We interviewed the Trustee and members of the trustee's counsel law firm on litigation and settlement issues, and we conducted legal research on the Trustee's legal basis for pursuing asset recovery actions. We also interviewed Securities and Exchange Commission (SEC) officials and executives of the Securities Investor Protection Corp. (SIPC) for their views on conduct of Madoff-related litigation.

To examine the effect of the Madoff fraud on customers' federal income tax liabilities, including potential differences based on how investor losses were calculated, we examined relevant portions of the Internal Revenue Code and Internal Revenue Service (IRS) revenue rulings and revenue procedures.<sup>4</sup> In addition, we reviewed a September 2011 audit by the Department of the Treasury Inspector General for Tax Administration. We also interviewed SEC and IRS officials, SIPC executives, and four individuals with income tax expertise, including a law professor and three tax advisors who we selected based on their tax experience or publications related to tax issues.

We conducted this performance audit from March to September 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>4</sup>A revenue ruling represents IRS conclusions on the application of law to the facts of a situation. A revenue procedure is a statement of a procedure that affects the rights or duties of taxpayers or other members of the public, or otherwise should be a matter of public knowledge.

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# Appendix II: Trustee Avoidance Actions and Other Claims

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Avoidance actions, often called “clawbacks,” enable a bankruptcy trustee to set aside certain transfers of property made by the debtor within specified periods preceding a bankruptcy filing, in order to recover the property for the benefit of the estate and its creditors. These actions are authorized by the federal Bankruptcy Code (title 11, United States Code) as well as state laws, which section 544(b) of the Bankruptcy Code makes available to bankruptcy trustees. Avoidance powers apply fully to trustees conducting liquidations under the Securities Investor Protection Act (SIPA).<sup>1</sup>

As discussed below, two types of avoidance actions authorized by the Bankruptcy Code are preferential transfers (or preferences) and fraudulent transfers. Fraudulent transfers are further subdivided into two types: actual fraud and constructive fraud. Individual lawsuits brought by trustees can (and in the Madoff liquidation, often do) include preference avoidance counts, avoidance counts alleging both constructive and actual fraud under the Bankruptcy Code, and avoidance counts arising under state law. Indeed, the bankruptcy court has affirmed the Madoff Trustee’s right to bring a wide range of avoidance claims under both the Bankruptcy Code and New York law.<sup>2</sup>

A trustee’s avoidance powers are especially strong when the liquidation involves a Ponzi scheme. This is because courts have developed a series of specific interpretive rules, including the “Ponzi scheme presumption,” which work to the advantage of the trustee and to the disadvantage of the

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<sup>1</sup>Section 6(b) of SIPA, 15 U.S.C. § 78fff(b), makes the Bankruptcy Code generally applicable to SIPA liquidations. Section 7(a), 15 U.S.C. § 78fff-1(a), vests in SIPA trustees “the same powers and title with respect to the debtor and the property of the debtor, including the same rights to avoid preferences, as a trustee” under the Bankruptcy Code. In addition, section 8(c), 15 U.S.C. § 78fff-2(c), provides that whenever customer property is not sufficient to fully pay all applicable claims, “the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void” under provisions of the Bankruptcy Code.

<sup>2</sup>*Picard v. Merkin (In re Bernard L. Madoff Investment Securities LLC)*, 440 B.R. 243 (Bankr. S.D.N.Y. 2010), *leave to appeal denied*, 2011 W.L. 3897970 (S.D.N.Y. 2011).

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recipients of money paid out by Ponzi schemers—particularly when it comes to recovering payments that represent fictitious profits.<sup>3</sup>

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## Preferential Transfers

Avoidance actions based on preferential transfers, which are governed by section 547 of the Bankruptcy Code, enable the trustee to avoid and recover payments the debtor made to creditors within 90 days preceding the bankruptcy filing, or up to 1 year prior to filing in the case of transfers to “insiders.”<sup>4</sup> Under section 547(b) of the Code, a trustee may avoid any transfer of a property interest of the debtor to or for the benefit of a creditor made within the preference period “for or on account of an antecedent debt” while the debtor was insolvent, if the transfer enabled the creditor to receive more than the creditor would have received without it under the bankruptcy distribution. The U.S. Supreme Court has observed that preference avoidance is a “mechanism [that] prevents the debtor from favoring one creditor over others by transferring property shortly before filing for bankruptcy.”<sup>5</sup>

There are several statutory exceptions to avoidance under section 547(c). For example, preference avoidance does not extend to payments of a debt incurred by the debtor “in the ordinary course of business.” However, the courts consistently hold that the concept of “ordinary course of business” has no application in a Ponzi scheme setting and, therefore, cannot provide a defense to preference avoidance. Furthermore, preference avoidance does not take account of the conduct of the recipient. Thus, it applies to all “transferees,” or recipients of transfers, including innocent victims of Ponzi schemes.

For the above reasons, a trustee usually has no difficulty avoiding as preferential transfers Ponzi scheme payments made during the

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<sup>3</sup>For a comprehensive description of the legal principles applicable to avoidance actions in Ponzi scheme liquidations and how they differ from other bankruptcies, see Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 73 Am. Bankr. L.J. 157 (Spring 1998).

<sup>4</sup>Section 101(31) of the Bankruptcy Code defines “insider” in the case of a company such as the Madoff firm to include directors, officers, partners, other persons in control of the company, and their relatives. The courts recognize the term “insider” also may extend to anyone with a sufficiently close relationship to the debtor that they do not deal at arm’s length. See, e.g., *In re Longview Aluminum, LLC*, 657 F.3d 507, 509-510 (7th Cir. 2011).

<sup>5</sup>*Begier v. IRS*, 496 U.S. 53, 58 (1990).



preference period. At the same time, the prevailing view is that preferential transfer actions can only reach payments that represent customer investments of principal in a Ponzi scheme—not fictitious profits. In the leading precedent on this subject, the court reasoned that since a Ponzi investor does not have a valid claim to fictitious profits, payouts based on them are not made on account of an “antecedent debt” as required for preference avoidance.<sup>6</sup> This limitation has little if any practical effect, however, since fictitious profits paid during the preference period are recoverable through the fraudulent transfer avoidance actions described below.

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## Fraudulent Transfers

Avoidance actions based on fraudulent transfers are governed by section 548 of the Bankruptcy Code. Section 548(a)(1) provides that a trustee may avoid any transfer of an interest of the debtor in property made within 2 years before the filing date—

- A. if the debtor made the transfer “with actual intent to hinder, delay, or defraud any entity” to which the debtor was or became indebted; or
- B. if the debtor received “less than equivalent value in exchange for” the transfer and was insolvent at the time of the transfer, became insolvent as a result of the transfer, was engaged in business for which the debtor’s remaining property provided unreasonably small capital, or met one of several other conditions specified in section 548(a)(1)(B).

Section 548 thus provides for two types of avoidance actions. An action based on section 548(a)(1)(A) is one for actual fraud. As the language indicates, it applies to transfers made by a debtor with actual intent to defraud. By contrast, an action based on section 548(a)(1)(B) is one for constructive fraud and does not require fraudulent intent on the part of the debtor. Instead, the key consideration is whether the transfer was made for less than equivalent value while the debtor was insolvent.

As a practical matter, the distinction between actual and constructive fraud under section 548 has little significance in the unique context of a Ponzi scheme, where the trustee is seeking to recover fictitious profits. By

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<sup>6</sup>*Wooton v. Barge (In re Ronald Cohen)*, 875 F.2d 508 (5th Cir. 1989).

virtue of the Ponzi scheme presumption, Ponzi scheme payouts are generally considered to be actually fraudulent. Case law has held that transfers beyond the principal investment lack value, making those transfers recoverable under the constructive fraud provisions. Thus, transfers of fictitious profits are subject to avoidance as both actual and constructive fraudulent transfers.

The concept of fraud under section 548(a) focuses on the debtor-transferor rather than the transferees. Thus, all recipients of Ponzi scheme payouts, innocent or otherwise, are potentially subject to avoidance actions based on both actual and constructive fraud. However, the recipients' status is important in determining the nature and extent of their liability. Section 548(c) of the Bankruptcy Code provides that the transferee in a fraudulent transfer avoidance action may retain any interest transferred upon showing that the interest was taken "for value and in good faith." Principal invested in a Ponzi scheme is considered value with respect to a good faith transferee in this context, while fictitious profits are not. In general, therefore, the liability of good faith recipients in a Ponzi scheme-related fraudulent transfer action will be limited to fictitious profits paid to "net winners"—that is, investors who withdrew more than they invested in the scheme. Recipients who cannot establish their good faith are liable for the return of their principal investment as well as any fictitious profits paid out during the 2-year avoidance period.

Good faith in an avoidance action is an affirmative defense, so the transferee has the burden of proof.<sup>7</sup> In this regard:

" . . . If the investor knew or should have known that the debtor's investment scheme was too good to be true, then the investor fails to carry his burden of proving that he accepted sums from the debtor in good faith, and the trustee is entitled to recover all amounts the investor received from the debtor."<sup>8</sup>

Judicial decisions vary on how to apply the "knew or should have known" standard. One line of precedent follows an "objective" or "reasonable person" test, whereby an investor has a duty to inquire into the legitimacy of transactions in the face of "red flags" that would make a reasonable

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<sup>7</sup>An affirmative defense is an assertion by a defendant, which, if proven, constitutes a defense to a charge or complaint.

<sup>8</sup>McDermott, note 3, 176-177 (footnotes omitted).

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investor suspicious.<sup>9</sup> Under this approach, an investor who fails to inquire into suspicious circumstances, or even one who inquires but conducts an inadequate inquiry, cannot establish a good faith defense. By contrast, other courts have applied a so-called “subjective” test, whereby investors are found to have acted in good faith so long as they lacked actual knowledge of the fraud or did not “turn a blind eye” in the face of obvious signs of fraud.<sup>10</sup> One recent U.S. District Court opinion in a Madoff-related case endorsed the subjective test of good faith.<sup>11</sup>

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## Avoidance Actions under New York Law

As noted, a trustee, including a SIPA liquidator, can bring avoidance actions under state law as well as the federal Bankruptcy Code. Since the Madoff firm was formed as a New York limited liability company with its principal place of business there, the Madoff Trustee’s avoidance actions include claims under New York’s fraudulent conveyance law, codified in sections 270 through 281 of the New York Debtor and Creditor Law (DCL) (McKinney 2012).

New York law does not provide for preference avoidance actions. However, it does contain fraudulent conveyance provisions that are similar to section 548 of the Bankruptcy Code. Sections 273 through 275 of the DCL are its constructive fraud provisions, authorizing the avoidance of transfers made without “fair consideration.”<sup>12</sup> Section 276 of the DCL provides for the avoidance of transfers based on actual fraud, using language similar to section 548(a)(1)(A) of the Bankruptcy Code:

“Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.”<sup>13</sup>

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<sup>9</sup>See, e.g., *In re Bayou Group, LLC*, 439 B.R. 284 (S.D.N.Y. 2010).

<sup>10</sup>See, e.g., *In re Teleservices Group, Inc.*, 444 B.R. 767 (Bankr. W.D.Mich. 2011).

<sup>11</sup>*Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011).

<sup>12</sup>“Fair consideration” is defined in DCL § 272.

<sup>13</sup>One potential difference between actual fraud avoidance under the Bankruptcy Code and New York law is that DCL § 276 may be interpreted to require a showing of fraudulent intent on the part of the transferee as well as the transferor. Court decisions applying § 276 are inconsistent on this point. See precedents described in *Picard v. Merkin*, note 2, 440 B.R. at 257.

Additionally, DCL section 276-a provides for the award of attorney fees in a successful avoidance action based on actual fraud where fraud on the part of the transferee is demonstrated.

The main difference between avoidance actions under the federal Bankruptcy Code and the DCL relates to the reach-back period. In contrast to the 2-year Bankruptcy Code reach-back, DCL constructive fraud avoidance actions are subject to the general 6-year statute of limitations in section 213(1) of the New York Civil Practice Law and Rules (CPLR) (McKinney 2012).<sup>14</sup> Thus, these actions can reach transfers made up to 6 years before the filing date.

Under CPLR sections 203(g) and 213(8), the reach-back period for actions based on actual fraud is 6 years before the filing date or 2 years from the time the fraud was discovered or could have been discovered with reasonable diligence, whichever date is earlier. The Madoff Trustee has used this authority to seek avoidance and recovery of fraudulent transfers occurring more than 6 years before the filing date where the recipients received the transfers in bad faith.

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## Other Considerations

**Claims by recipients of avoidable payments.** Section 502(d) of the Bankruptcy Code generally requires disallowance of any claim against the bankruptcy estate by the recipient of an avoidable transfer, unless the recipient has paid over the avoidable amount. The Madoff Trustee has invoked this authority in seeking to temporarily disallow SIPA claims and other claims brought by some defendants in avoidance actions.

**Subsequent transferees.** Under section 550 of the Bankruptcy Code, the trustee can seek recovery of the proceeds of an avoided transaction from not just the initial transferee but also from “subsequent transferees”—third parties who obtained funds from those receiving funds directly from the bankrupt entity. Thus, for example, the Madoff trustee can maintain avoidance actions against Madoff investors who received payouts through feeder funds or other intermediaries. However, there are limits to this authority. For example, a trustee cannot recover from a subsequent transferee who can show receipt of the proceeds for value, in

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<sup>14</sup>See *Dowlings, Inc. v. Homestead Dairies, Inc.*, 88 A.D.3d 1226, 1229-30, 932 N.Y.S.2d 192, 196-97 (2011), and cases cited.

good faith, and without knowledge that the transfer was avoidable. Also, an action under section 550 generally must be commenced within 1 year after the avoidance of the transfer for which recovery is sought against.

Like the Bankruptcy Code provisions, sections 278 and 279 of the DCL authorize avoidance and recovery against subsequent transferees, except purchasers for fair consideration without knowledge of the fraud.

**Stockbroker safe harbor.** One important area of uncertainty concerning securities-related Ponzi scheme avoidance actions is the applicability of the so-called “stockbroker safe harbor” or “stockbroker defense” provided in section 546(e) of the Bankruptcy Code. This provision exempts certain securities transactions from avoidance actions except those alleging actual fraud.<sup>15</sup> Thus far, Madoff-related judicial decisions have reached different conclusions regarding the applicability of section 546(e). The bankruptcy court held that section 546(e) did not apply to the Madoff Ponzi scheme,<sup>16</sup> while a district court held that it did.<sup>17</sup>

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## Other Claims

A number of lawsuits the Madoff trustee has filed against bad faith transferees contain common law claims in addition to avoidance counts under the Bankruptcy Code and the New York DCL. These claims include, for example, counts for conversion, unjust enrichment, and money had and received.

A trustee has the authority and standing to sue to enforce claims that the debtor had prior to bankruptcy that represent property of the estate, including common law claims.<sup>18</sup> However, two recent U.S. District Court decisions dealing with the Madoff liquidation emphasized limits on the

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<sup>15</sup>Section 546(e) provides in part: “Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a . . . stockbroker . . . or that is a transfer made by or to (or for the benefit of) a . . . stockbroker . . . in connection with a securities contract, as defined in section 741(7), . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.”

<sup>16</sup>*Picard v. Merkin*, note 2.

<sup>17</sup>*Picard v. Katz*, note 11.

<sup>18</sup>See, e.g., *Bankruptcy Code* §§ 321, 541(a); *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff)*, 429 B.R. 423 (Bankr. S.D.N.Y. 2010), *aff'd*, 848 F. Supp.2d (S.D.N.Y. 2012).

Madoff Trustee's ability to pursue common law claims.<sup>19</sup> In both cases, the courts concluded that the Trustee could not pursue certain common law claims that, in the courts' view, more appropriately belonged to creditors rather than the debtor and the estate. Furthermore, with respect to debtor claims, the courts noted that Madoff and his firm were wrongdoers, and that the Trustee stands in their shoes for purposes of pursuing common law claims. Therefore, the courts concluded, such claims would be subject to the legal principle that bars resolution of disputes between one wrongdoer and another.<sup>20</sup>

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<sup>19</sup>*Picard v. JP Morgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2011), and *Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y. 2011).

<sup>20</sup>This legal principle against adjudicating wrongdoer versus wrongdoer claims is called "*in pari delicto*."

# Appendix III: Largest Madoff Accounts by Transaction Volume, Total Withdrawals, and Net Winnings

We obtained and analyzed transaction data for customers of the failed Bernard L. Madoff Investment Securities, LLC firm. Table 10 shows account information and status for the 10 largest Madoff accounts by transaction volume.

**Table 10: Ten Largest Madoff Accounts by Transaction Volume**

(Dollars in millions)

Account name <sup>a</sup>	Transaction volume <sup>b</sup>	Net investment position <sup>c</sup>	Final statement account balance <sup>d</sup>	Status
NORMAN F LEVY C/O KONIGSBERG WOLF & CO	\$222,322	-\$61	\$0	As part of settlement with Trustee that included 39 Levy-related accounts, Levy heirs will repay \$220 million in withdrawals of fictitious profits. Settlement appealed by other Madoff customers.
CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD	\$8,487	\$509	\$3,226	Settlement reached covering four accounts, in which the funds' claims were reduced by almost \$1 billion, while providing \$70 million to customer property fund. The funds retained allowed claims of \$230 million.
CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD	\$8,453	\$554	\$3,248	
DECISIONS INCORPORATED	\$6,397	-\$6,162	-\$5,388	Account owned by Jeffrey Picower. Under settlement with Trustee, Picower estate agreed to repay all \$7.2 billion in net withdrawals from 34 accounts, \$5 billion to Trustee and \$2.2 billion to U.S. Department of Justice.
FAIRFIELD SENTRY LIMITED C/O FAIRFIELD GREENWICH GROUP	\$4,771	\$14	-\$95	See CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD, above.
FAIRFIELD SENTRY LIMITED C/O FAIRFIELD GREENWICH GROUP	\$4,745	\$0	-\$95	
HARLEY INTERNATIONAL FUND LTD C/O FORTIS PRIME FUND SOLUTION	\$3,500	\$1,279	\$2,578	Did not file claim to recover losses. Not involved in Madoff-related litigation or settlements.
RYE SELECT BROAD MKT FUND LP C/O TREMONT PARTNERS	\$2,442	\$1,648	\$2,346	One of accounts of Tremont Group Holdings, Inc. Trustee sought to recover \$2.1 billion in withdrawals by Tremont Group, alleging it knew or should have known of warning signs about Madoff firm. Under settlement with Trustee, Tremont Group will pay \$1 billion and have allowed claims of \$3 billion.

**Appendix III: Largest Madoff Accounts by Transaction Volume, Total Withdrawals, and Net Winnings**

Account name <sup>a</sup>	Transaction volume <sup>b</sup>	Net investment position <sup>c</sup>	Final statement account balance <sup>d</sup>	Status
UBS (LUXEMBOURG) SA FBO LUXALPHA SICAV	\$2,346	\$762	\$1,299	Trustee filed complaint seeking recovery of about \$2 billion in withdrawals. Complaint partially dismissed by U.S District Court judge.
HSBC SECURITIES SERVICES (LUXEMBOURG) SA SPEC CUST ACCT	\$2,313	\$1,178	\$1,894	Trustee filed complaint seeking \$2 billion in withdrawals and \$6.6 billion in damages. Complaint partially dismissed by U.S. District Court judge, and Trustee has appealed.

Source: GAO analysis of Madoff Trustee data and court filings.

<sup>a</sup>The name listed on the account. Some entities had multiple accounts under the same or similar names. Each row in this table represents a single account.

<sup>b</sup>The sum of all deposits and withdrawals.

<sup>c</sup>The net investment position of the account at the time of the Madoff firm failure. Positive net investment positions represent deposits in excess of withdrawals; negative net investment positions indicate withdrawals in excess of deposits.

<sup>d</sup>The account balance listed on the final statement for the account.

Table 11 shows account information and status for the 10 largest Madoff accounts by total withdrawals.

**Table 11: Ten Largest Madoff Accounts by Total Withdrawals**

(Dollars in millions)

Account name <sup>a</sup>	Total withdrawals <sup>b</sup>	Total deposits <sup>c</sup>	Net investment position <sup>d</sup>	Final statement account balance <sup>e</sup>	Status
NORMAN F LEVY C/O KONIGSBERG WOLF & CO	\$111,126	\$111,192	-\$61	\$0	See NORMAN F LEVY C/O KONIGSBERG WOLF & CO in table 10 above.
DECISIONS INCORPORATED	\$6,279	\$117	-\$6,162	-\$5,388	See DECISIONS INCORPORATED in table 10 above.
CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD	\$3,989	\$4,497	\$509	\$3,226	
CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD	\$3,949	\$4,504	\$554	\$3,248	See CITCO GLOBAL CUSTODY N V FBO FAIRFIELD SENTRY LTD in table 10 above.
FAIRFIELD SENTRY LIMITED C/O FAIRFIELD GREENWICH GROUP	\$2,378	\$2,392	\$14	-\$95	
FAIRFIELD SENTRY LIMITED C/O FAIRFIELD GREENWICH GROUP	\$2,373	\$2,373	-\$0	-\$95	



**Appendix III: Largest Madoff Accounts by  
Transaction Volume, Total Withdrawals, and  
Net Winnings**

<b>Account name<sup>a</sup></b>	<b>Total withdrawals<sup>b</sup></b>	<b>Total deposits<sup>c</sup></b>	<b>Net investment position<sup>d</sup></b>	<b>Final statement account balance<sup>e</sup></b>	<b>Status</b>
HARLEY INTERNATIONAL FUND LTD C/O FORTIS PRIME FUND SOLUTION	\$1,111	\$2,389	\$1,279	\$2,578	See HARLEY INTERNATIONAL FUND LTD C/O FORTIS PRIME FUND SOLUTION in table 10 above.
RYE SELECT BROAD MARKET PRIME FUND, LP	\$1,010	\$799	-\$211	\$596	See RYE SELECT BROAD MKT FUND LP C/O TREMONT PARTNERS in table 10 above.
UBS (LUXEMBOURG) SA FBO LUXALPHA SICAV	\$752	\$1,554	\$802	\$1,299	See UBS (LUXEMBOURG) SA FBO LUXALPHA SICAV in table 10 above.
ASCOT PARTNERS LP	\$748	\$974	\$226	\$1,862	One of the feeder funds created by J. Ezra Merkin. As part of settlement with New York Attorney General, Merkin agreed to pay \$405 million to certain customers. Trustee filed separate complaint, seeking \$500 million in withdrawals, and is seeking injunction against the settlement between Merkin and clients, arguing it violates automatic stay provisions of Bankruptcy Code and stay orders of district court.

Source: GAO analysis of Madoff Trustee data and court filings.

<sup>a</sup>The name listed on the account. Some entities had multiple accounts under the same or similar names. Each row in this table represents a single account.

<sup>b</sup>The sum of all withdrawals made from the account.

<sup>c</sup>The sum of all deposits made into the account.

<sup>d</sup>The net investment position of the account at the time of the Madoff firm failure. Positive net investment positions represent deposits in excess of withdrawals; negative net investment positions indicate withdrawals in excess of deposits.

<sup>e</sup>The account balance listed on the final statement for the account.

Table 12 shows account information and status for the 10 largest Madoff accounts by “net winnings,” that is, the amount by which an account holder withdrew more than they invested in the Madoff firm.

**Appendix III: Largest Madoff Accounts by  
Transaction Volume, Total Withdrawals, and  
Net Winnings**

**Table 12: Ten Largest Madoff Accounts by Net Winnings**

(Dollars in millions)

<b>Account name<sup>a</sup></b>	<b>Transaction volume<sup>b</sup></b>	<b>Net investment position<sup>c</sup></b>	<b>Final statement account balance<sup>d</sup></b>	<b>Status</b>
DECISIONS INCORPORATED	\$6,397	-\$6,162	-\$5,388	See DECISIONS INCORPORATED in table 10 above.
JEANNE LEVY-CHURCH	\$742	-\$573	-\$1,699	Account associated with Norman F. Levy. See NORMAN F LEVY C/O KONIGSBERG WOLF & CO in table 10 above.
THE LAMBETH CO	\$649	-\$378	\$402	Among accounts owned or associated with Stanley Chais. Trustee seeking repayment of \$1.2 billion in withdrawals.
JA PRIMARY LTD PARTNERSHIP	\$287	-\$250	\$0	Most recent transaction was 1996, and account not involved in litigation.
THE PICOWER FOUNDATION	\$367	-\$242	\$598	See DECISIONS INCORPORATED in table 10 above.
THE BRIGHTON COMPANY	\$367	-\$233	\$384	See THE LAMBETH CO above.
AVELLINO & BIENES #5 C/O FRANK AVELLINO	\$299	-\$213	\$0	Account used by feeder fund created by Frank Avellino and Michael Bienes; the first Madoff feeder fund, according to Trustee. Trustee is seeking repayment of \$905 million in withdrawals from accounts associated with Avellino and Bienes.
RYE SELECT BROAD MARKET PRIME FUND, LP	\$1,809	-\$211	\$596	See RYE SELECT BROAD MKT FUND LP C/O TREMONT PARTNERS in table 10 above.
CARL SHAPIRO TRUST U/D/T 4/9/03	\$547	-\$201	\$56	Among accounts owned by Carl Shapiro or family. Family agreed to \$625 million settlement, which is lower than \$1 billion Trustee sought to recover withdrawals of fictitious profits. Shapiro family contended Trustee did not properly account for \$500 million in deposits.
FRANCIS N LEVY C/O KONIGSBERG WOLF & CO PC	\$378	-\$193	-\$1,149	Account associated with Norman F. Levy. See NORMAN F LEVY C/O KONIGSBERG WOLF & CO in table 10 above.

Source: GAO analysis of Madoff Trustee data and court filings.

<sup>a</sup>The name listed on the account. Some entities had multiple accounts under the same or similar names. Each row in this table represents a single account.

<sup>b</sup>The sum of all deposits and withdrawals.

<sup>c</sup>The net investment position of the account at the time of the Madoff firm failure. Positive net investment positions represent deposits in excess of withdrawals; negative net investment positions indicate withdrawals in excess of deposits.

<sup>d</sup>The account balance listed on the final statement for the account.

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# Appendix IV: Details of Settlements by the Madoff Trustee

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In hundreds of cases, the Madoff Trustee has reached settlements with former customers and others, either before or after filing clawback actions, and these agreements have produced recovery of a significant amount of assets. This appendix provides details of these settlements, including amounts sought and obtained, the extent to which settlements have been paid, strategies behind settlements, and key provisions.

As of April 2012, the Trustee had entered into 441 settlement agreements in which the opposing parties agreed to return about \$8.4 billion—an amount equal to about 49 percent of the approximately \$17.3 billion in principal investments lost by customers who filed claims. Based on a bankruptcy court review threshold, we examined all but one settlement agreement worth at least \$20 million.<sup>1</sup> Table 13 provides a summary of the 13 settlements we identified. These settlements account for more than 97 percent of all settlement amounts. They include settlements from family estates, such as Picower, Shapiro, and Levy, as well as feeder funds, in the case of UBP, Optimal, Fairfield, Mount Capital, and Trotanoy Investment.<sup>2</sup> The group also includes settlements with charitable foundations and the federal government. As the table shows, the amounts collected by individual case vary widely.

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<sup>1</sup>The \$20 million Hynes settlement (see table) was sealed for confidentiality, with the Trustee having filed no adversary action. Thus, details were unavailable to us.

<sup>2</sup>Feeder funds are investment vehicles that collected money from investors and channeled the funds to the Madoff firm.

Appendix IV: Details of Settlements by the Madoff Trustee

**Table 13: Madoff Settlement Agreements of at Least \$20 Million**

(Dollars in millions)

Case	Case type	Amount initially sought	Settlement amount	Settlement amount as percentage of all settlements	Payments received as of July 2012	Percentage of settlement received
Picower <sup>a</sup>	Investor	\$7,200	\$5,000	59.6%	\$5,000	100%
Tremont	Feeder fund	\$2,100	\$1,025	12.2		0
Shapiro	Investor	\$1,045	\$550	6.6	\$550	100
UBP	Feeder fund	\$1,000	\$470	5.6	\$470	100
IRS <sup>b</sup>	Government	\$326	\$326	3.9	\$326	100
Optimal	Feeder fund	N/A <sup>c</sup>	\$233.8	2.8	\$233.8	100
Levy	Investor	\$221	\$220	2.6	\$220	100
Katz-Wilpon	Investor	\$1,018	\$162	1.9		0
Fairfield	Feeder fund	\$3,054	\$70	0.8	\$18.3	26.2
Hadassah <sup>d</sup>	Charitable foundation	\$77	\$45	0.5	\$45	100
Mount Capital	Feeder fund	\$46	\$43.5	0.5	\$43.5	100
Trotanoy Investment	Feeder fund	\$182.4 plus damages at trial	\$29	0.3		0
Hynes	N/A	N/A	\$20	0.2	\$20	100
<b>Total</b>			<b>\$8,194</b>	<b>97.6%</b>	<b>\$6,927</b>	<b>84.5%</b>

Source: Madoff Trustee, GAO analysis.

<sup>a</sup>The Picower settlement totals \$7.2 billion and has two parts: \$5 billion for the Trustee and \$2.2 billion for the U.S. Department of Justice civil forfeiture program. The Trustee told us that in the case of such dual settlements, the Trustee first obtained his desired settlement, and then any other amounts were added on. Thus, amounts recovered by other parties did not reduce amounts obtained by the Trustee, he said.

<sup>b</sup>To recover purported tax withholdings Madoff made for foreign investors. The Trustee said Madoff collected and paid more than \$330 million to IRS, but some foreign account holders settled separately with the IRS before the Trustee reached his agreement. The Trustee's settlement with IRS reflects the balance.

<sup>c</sup>Clawback action not filed; no amount formally sought.

<sup>d</sup>As discussed earlier, the Trustee alleged Hadassah received at least \$77 million in avoidable transfers, but settled at the lower amount in consideration of the organization's charitable activities.

Among these settlements, the Optimal case has played an influential role, the Trustee told us. Optimal was the sponsor of two feeder funds, and it was an early case with potentially risky legal issues present, such as jurisdiction and foreign entities—it was not clear the U.S. Bankruptcy Code or SIPA apply outside the United States, the Trustee told us. The Trustee secured an agreement requiring Optimal to return 85 percent of amounts received during the 90-day preference period. Included was a

term providing that if the Trustee settled with another party on more advantageous terms, Optimal would also receive those terms.

The 85 percent figure effectively became the benchmark for settlements of similar claims, the Trustee told us. In turn, the Trustee also set a complementary benchmark for good faith claims at 95 percent, in consideration of the comparative ease in making such cases compared to bad faith actions. The Trustee told us that in the Optimal settlement, he considered it important to secure the agreement in order to build the customer fund. However, looking back, he said the “most favored nation” provision has been an issue. Optimal recently attempted to invoke the clause following the Trustee’s recent settlement with Hadassah. Due to the complexity of these cases, it is difficult to discern what constitutes a settlement to which the clause would apply, the Trustee said.

Based on our examination of the largest settlement agreements, table 14 provides a summary of key settlement provisions.

**Table 14: Key Provisions among Largest Madoff Settlements**

Settlement	Key provisions
Optimal	“Most favored nation” clause where Optimal agreed to pay 85 percent of amounts received during 90-day preference period, but if another party gets more favorable agreement, Optimal gets those terms.
Fairfield	\$1.2 billion in customer claims reduced to \$230 million. Trustee and liquidator of feeder funds involved agreed to share in recoveries from feeder funds’ officers and management companies involved. Trustee said partnership aligns interests of both parties and enhances prospects of recovery.
Tremont	Defendants do not share in settlement proceeds, as they forego profits through fees, earnings, management expenses. Trustee says refusal to “settle cheap”—initial settlement offer was \$176 million, versus \$1.025 billion eventually obtained—established credibility.
IRS	IRS agreed to return to Trustee funds Madoff had collected from foreign account holders as income tax withholdings. Foreign account holders cannot bring actions against IRS, United States, or the Trustee in the future.
Katz-Wilpon	Claims defendants had following collapse of Madoff firm become assets to fund settlement. Katz and Wilpon personally guarantee up to \$29 million if other defendants do not pay.
Hadassah	Settled \$77 million case for \$45 million, to avoid causing failure of Israeli hospital funded by defendant.
Picower, Levy	Recovered all, or nearly all, of eligible fictitious profits; parties’ claims for losses also withdrawn.

Source: Madoff Trustee and GAO review of settlement agreements filed by the Trustee.

The Trustee's settlement agreements also go beyond simply obtaining cash agreements, we found, as allowance of customer claims and SIPC advances have also been key components of settlements of feeder fund cases. For example, the Tremont settlement, in addition to its \$1.025 billion settlement amount, also included allowing more than \$3 billion in customer claims and granting SIPC advances for eligible accounts. With the exception of the Katz-Wilpon case, all seven settlements that included allowed customer claims as part of the agreement were feeder fund cases. Because these feeder funds were net losers, the settlement agreements granted SIPC advances to each of the funds that directly held Madoff accounts. In the Katz-Wilpon agreement, the allowed customer claim was assigned to the Trustee, so that customer distributions will fund the \$160 million settlement payment.

For both the Picower and Levy settlements, the Trustee told us he believed he obtained the largest sums possible. The \$5 billion settlement in the Picower case represents 100 percent repayment of funds received by the Picower estate and related investors named in the complaint. Similarly, the Levy settlement, reached before litigation was filed, represents nearly 100 percent of the amounts the Levy account holders withdrew during the 6 years prior to the Madoff firm's collapse.<sup>3</sup> Additionally, both Picower and Levy withdrew their customer claims as part of the settlements, the Trustee said.

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<sup>3</sup>This does not include \$84 million paid to the Levy foundation, which the Trustee did not seek to recover, because the funds had been donated to charitable causes.

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# Appendix V: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Staff Acknowledgments

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