

MOSES & SINGER LLP

Memorandum

Date: March 20, 2009

To: Interested Persons

From: Moses & Singer LLP

Re: **Bernard L. Madoff Investment Securities LLC - Update**

Moses & Singer LLP is representing a number of clients in connection with the events surrounding the collapse of Bernard L. Madoff Investment Securities LLC (“BLMIS”). Our clients include individuals and funds who invested directly in BLMIS and others who invested indirectly through hedge funds, funds of funds or other private investment vehicles. This memo summarizes certain recent developments and some of the attendant legal issues.

Criminal Proceeding

On March 12, 2009, Bernard Madoff pleaded guilty and was remanded to prison. Sentencing is set for June 16, 2009. The US Attorney’s office is continuing to investigate who else was involved with the fraud. As part of the criminal proceeding, the US Attorney has asked for the forfeiture of \$170 billion it claims were the proceeds of the fraud and is seeking all of the assets held by the Madoffs. Mr. Madoff’s attorneys have asserted that the net amount after giving effect to distributions to investors is much smaller, and that assets held by Mrs. Madoff alone are not subject to forfeiture.

SIPC Trustee

Irving Picard, the SIPC-appointed SIPC Trustee for BLMIS (the “SIPC Trustee”), continues his liquidation of the BLMIS assets. To date, he has located approximately \$1 billion in assets. He has also announced that, based on his investigations, it does not appear that there were any securities transactions since at least 1993. Lee Richards, who had originally been appointed as receiver, and who had remained the trustee of Madoff International after the appointment of the SIPC Trustee, has resigned.

SIPC Process

The SIPC Trustee mailed approximately 8,000 claim forms; as of February 20, 2009, he announced he had received approximately 2,400 claims. As of the date of this memo, the SIPC Trustee had allowed 12 customer claims, paying each of those claimants the \$500,000 maximum under SIPC. Since there were no securities transactions, the SIPC Trustee has concluded that the

initial March 2nd date (which would have been relevant for return of customer securities) was inapplicable and July 2, 2009 will be the bar date for all claims.

At the meeting of creditors on February 20, 2009, the SIPC Trustee announced that, even though there apparently were no securities, he would treat the claims as claims for securities so that the SIPC \$500,000 security limit would apply as opposed to the \$100,000 cash limit. However, he also announced that he would view customer claims on “net-cash basis” — looking at the aggregate cash amount invested by the customer, and the aggregate cash returns received by the customer. He did not intend to give any effect to “phantom profits.” He also announced that to the extent a particular customer was subject to claw-back claims (which include claims based on fraudulent conveyance and preference), he would not pay amounts to that customer unless the claw-back claims were resolved. The SIPC Trustee announced his intention to enforce the claw-back claims, but suggested that he might take particular individual circumstances into account.

The SIPC Trustee’s avowed intent to pursue claw-back claims highlights the risk for filing by BLMIS investors who are at risk for substantial claw-back claims. By filing, an investor is consenting to the jurisdiction of the Bankruptcy Court (and arguably waiving the right to a jury trial), and making admissions that might be damaging in any claw-back proceeding. Thus, any investor who is subject to a substantial claw-back risk should seek advice as to whether it is, in fact, advisable to file a claim under SIPC.

Claw-Back Claims

(i) Preferences. Investors in BLMIS who received distributions from and after September 12, 2008 (90 days prior to the bankruptcy filing on December 11, 2008) are subject to having their distribution reclaimed by the SIPC Trustee as a preference. The ability to reclaim a distribution made during this period has nothing to do with whether an investor is in a net profit or net loss position — it is a right of the SIPC Trustee to make sure investors who received distributions shortly before the bankruptcy filing are not favored over other creditors.

(ii) Fraudulent Conveyance. More significant is the SIPC Trustee’s right to assert fraudulent conveyance claims. This arises because, given the nature of the BLMIS ponzi scheme, all distributions to investors are arguably fraudulent conveyances. The SIPC Trustee can seek to recover the entire amount of the distribution so that anyone who previously received a distribution is treated on a *pro rata* basis with all other customers. In certain instances, there is the ability to protect up to the amount originally invested, which is dependent on the good faith of the investor. Certain court cases interpreting the good faith requirement have concluded that if, in essence, the investment was “too good to be true”, the investor was ignoring “badges of fraud” and was not acting “in good faith” when it took the distribution. The SIPC Trustee has not articulated how he intends to proceed on these issues.

The SIPC Trustee has the power to assert claims not just against the initial recipient of the fraudulent conveyance but in certain instances against subsequent transferees. As a result, an investor in a feeder fund may be exposed if the feeder fund is subject to a claw-back claim and amounts have been distributed to the feeder fund investor.

There is some case law that suggests that customers are entitled to some court-determined rate of return on amounts invested, not just the return of their principal amount. However, the applicability of these cases to the BLMIS matter is not clear as the analysis is highly dependent on the facts and circumstances of each investor. Further, even if some rate of return is applied in determining the claw-back exposure of a particular investor, it is unlikely such a rate of return would be applied in determining any SIPC recovery.

Feeder and Other Investment Funds

A number of investors invested in BLMIS through an investment vehicle. Some of these vehicles were large “fund of funds” or hedge funds which had an investment in BLMIS, in some cases representing all or a substantial portion of the amounts invested in the fund, and in others a much smaller portion. In other cases, the “feeder fund” was a more informal arrangement, consisting of friends and family who were pooling their investments, in some instances at the suggestion of BLMIS. The SIPC Trustee has announced that he does not intend to extend SIPC protection to feeder fund investors. Certain feeder fund investors disagree with the SIPC Trustee’s position and assert that such investors should be entitled to SIPC protection. It appears that this issue will be litigated and determined by the court. The SIPC Trustee has suggested that investors in feeder and other funds file a protective claim, to insure their claims would not be barred if such investors are determined to be entitled to SIPC protection. Accordingly, there may ultimately be a basis for customers of feeder funds or other investment vehicles to make a SIPC claim in certain circumstances. However, as noted above, there are substantial concerns in some instances about filing a SIPC claim, and the solicitation of claims may be an attempt by the SIPC Trustee to bring more people into bankruptcy court. A number of funds have communicated with their investors, laying out the option of filing a claim. Perhaps in recognition of some of the risks involved, some funds have suggested that no distribution information be provided, but only a statement of net asset value as of the filing date. It is unclear how the SIPC Trustee would respond to a claim where this information is not provided.

Substantial litigation has already commenced against certain of the funds and associated parties, including control persons, administrators and accountants. At least two financial institutions that funneled money into BLMIS (Banco Santander and Union Bancaire Privée) have offered a settlement to its customers who invested in BLMIS.

In addition to the SIPC and litigation issues concerning feeder funds, the entire claw-back issue becomes much more complicated when dealt with through feeder funds. For example, in addition to whether the investor is in a net profit position, the position of the fund becomes relevant, as well as the question as to whether amounts received by the investor can be attributed to BLMIS.

Taxes

On March 17, 2009, the Internal Revenue Service (IRS) issued guidance to taxpayers who have incurred losses in ponzi-type investment schemes, including taxpayers that have incurred losses in connection with BLMIS. The guidance generally serves to clarify existing law and provides that an investor will be entitled to a theft loss, which is not a capital loss and thus is not subject to the \$3,000 per year limitation on capital losses from investments.

The guidance clarifies that “investment” theft losses are not subject to limitations that are applicable to “personal” casualty and theft losses. Although the loss is deductible as an itemized deduction, it is not subject to the 10 percent of adjusted-gross-income reduction that applies to many casualty and theft loss deductions.

The theft loss is deductible in the year the fraud is discovered — 2008 for BLMIS investors. The amount of the loss deduction is reduced by amounts for which there exists a “reasonable prospect of recovery.” Evaluating a reasonable prospect of recovery for a theft is highly fact-intensive and can be the source of much uncertainty, in particular where litigation against the promoter and other potentially liable third parties extends into future taxable years.

Recognizing this, the IRS has established a “safe harbor” procedure that certain taxpayers may elect to follow. Under the safe harbor, taxpayers that have invested directly (as opposed to indirectly through a separate entity such as a fund) in a qualifying fraudulent investment, such as BLMIS (“qualified investors”), may generally deduct in the year of discovery 95 percent of their unrecovered investment less the amount of any actual recovery in the year of discovery and less the amount of any recovery expected from private or other insurance, such as that provided by SIPC. A special rule applies to qualified investors who are also suing persons other than the individual or entities (such as BLMIS) that conducted the fraudulent arrangement. These investors compute their deduction by substituting “75 percent” for “95 percent” in the formula above.

The amount of the theft loss includes the investor's unrecovered investment, including income reported in past years. The guidance concludes that the investor generally can claim a theft loss deduction not only for the net amount invested, but also for the so-called “fictitious income” that the promoter of the scheme credited to the investor’s account and which the investor reported as income on his or her tax returns for years prior to discovery of the theft.

The IRS expressly declined to address the possibility of taxpayers amending tax returns for years prior to the discovery of the theft to exclude the fictitious income and receive a refund of tax for those years. Moreover, the “safe harbor” discussed above is conditioned on taxpayers not amending prior year returns.

A theft-loss deduction that creates a net operating loss for the taxpayer can generally be carried back 3 years and forward 20 years. Given that the theft losses in question are treated as business losses, investors that satisfy a new definition for small business, which applies only for 2008, are permitted to carry back their net operating losses for up to five years. Under the new, temporary definition, an investor will qualify for small business treatment and, hence, the extended carryback period, if the investor’s income does not exceed an average of \$15 million for the three prior years.

Finally, investors should also consider gift and estate tax returns. To the extent that gift or estate tax returns were artificially inflated by the value of BLMIS or similar holdings, it may be appropriate to amend them accordingly.

Insurance

A number of clients have insurance policies which cover theft. Although these policies generally have low dollar limits (typically a few thousand dollars), they may also have separate policy limits for each year of a BLMIS investment so that it may be possible that the aggregate amounts become more meaningful. It is certainly an avenue of recovery to be explored. However, there are typically strict (and short) notice provisions that must be complied with.

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Moses & Singer is monitoring the developments surrounding this complex situation and has established a group of attorneys who are familiar with the relevant issues. If you have any further questions concerning the factors you should be considering in determining whether to file a SIPC claim form, or your rights or liabilities more generally, you should call your regular contact at Moses & Singer, or one of the attorneys heading Moses & Singer's representation of BLMIS-related matters: Allan Grauberd (212-554-7883); Howard Herman (212-554-7847); or Alan Kolod (212-554-7866).

**NOTICE:**

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