Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1384

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From: Steve Leimberg's Estate Planning Newsletter
Subject: Revelations of Bernie Madoff's Fraud - The Day The Music Died

"Even this year, amid the stock market's worst performance since the Great Depression, Madoff was telling investors they were making money. Through Nov. 30, investors in the Rye Select Broad Market Fund were told they had earned 8.26 percent", according to an investor statement obtained by the Boston Globe."

Jeffrey A. Baskies is a Florida Bar certified expert in Wills, Trusts and Estates law who practices at **Katz Baskies LLC** a Boca Raton, FL boutique trusts & estates, tax & business law firm.
Jeff uses some recent headline news to remind planners of the importance of some very elemental practice principles, the importance of protecting principal, and the importance of practicing principles.

EXECUTIVE SUMMARY:

This is a report on what may be the single largest con game in history – and the lessons **LISI** professionals should be sharing with clients.

FACTS:

INTRODUCTION:

Thursday December 11, 2008 was surreal. In the afternoon, there was a frenzy of phone calls, emails, and text messages. "Rumors" – which unfortunately appear to be all too true and real - were frantically flying. Clients, friends, financial advisors, and lawyers were all connected and were all talking about one thing:

"Did you hear that Bernie Madoff was arrested and his investment firm was a Ponzi scheme?"

The accounts are still developing, but apparently Bernard Madoff's investment firm bilked investors out of $17-50 billion (or maybe more – perhaps much more).

While Madoff may not have been well known to everyone, in New York, Massachusetts and South Florida, Madoff's legend was well known – particularly in Jewish circles (as it seemed most of his investors shared that faith). It has been said that no large divorce happened in Palm Beach without a fight over the Madoff account.

If you didn't know of him before the recent accounts, Madoff built a reputation as a "miracle worker," *never* having a down year, regardless of the markets. His clients experienced 25+ years of fantastic returns. And his firm had an air of specialness about it. Madoff Securities was exclusive and only a select few were allowed to invest. The stories are legion of people who tried to give Madoff money but were turned away.

However, the recent economic tsunami that has revealed several financial crises already also overtook Bernie Madoff. While his Ponzi scheme of using new investor money to pay off old worked for nearly 30 years, this recession was too much. Reportedly, investors sought to withdraw approximately $7 billion (estimated to be about 40% of the total assets the firm was supposed to have under management). When Madoff realized he could not satisfy the withdrawal requests, he apparently told his staff and family that the firm had barely a few hundred million dollars left and was nothing more than a big Ponzi scheme. After telling of the ruin of his firm, Madoff was arrested later that day.

The FBI is investigating and the SEC took over his investment firm. With armed guards and literally working round the clock, federal investigators are trying to assess the full magnitude of the damage. For the sake of the investors, let's hope they uncover some kernel of value.

THE DAY THE MUSIC DIED:

It was very difficult to hear the stories from clients. It is almost impossible to imagine the magnitude of the harm. Several clients feared losing their entire net worth - outside their homes and checking accounts, they said, *all* their money was with Madoff. A friend and client advised that his entire IRA (on which his retirement rested) was 100% with Madoff. Other advisors shared similar stories of clients devastated and previously "wealthy" retirees who are now on the precipice of poverty.

Indeed, December 11 was surreal. To me, it felt like being hit by a sucker punch.

In searching for a way to summarize my feelings that evening, a fair analogy might be to the day in 1959 when Buddy Holly, Ritchie Valens and the Big Bopper all died in a plane crash. According to the story, reading the newspaper headlines the next morning inspired Don McLean to write "American Pie" – to write about the day the music died. www.don-mclean.com .

The revelations of Madoff's fraud evoked similar feelings. While the economic downturns in the market hurt virtually all our clients, the downfall of Madoff's firm was swifter and more deadly (in a financial sense) to a subset of clients. In some respects the crash of Madoff's firm was analogous to the death of a legend in a plane crash. It was halting and sudden. And for many of us, even if we were not investors, the impact was somewhat personal.

Working in South Florida, Madoff investors were ubiquitous. So many clients (particularly transplants from New York) were also clients of his firm. Very frequently, our clients referred to him and his firm as a miracle. The performance had been positive in all markets (even the worst bear markets) and somehow their accounts grew at a double-digit pace year in and year out. Some were so lulled by Madoff's work they called his equity fund "bond-like".

So many clients had invested with Bernie Madoff that the impact of his confessed Ponzi scheme will be widespread. And what marks this differently from all the other beatings clients have taken in the markets is the *totality* of the devastation. While many clients have lost 40-50% of their net worth in the tsunami of economic decline we've faced (between stocks – domestic and international – bonds and real estate losses), most still have positions they hold onto and the hope that someday (maybe years from now), these investments will recover.

But for clients who placed their life-savings with Bernie Madoff, there appears no such hope. The loss may be total, complete and catastrophic. Their hope is the SEC and FBI can muster some equity and perhaps the SIPC will cover some of the loss. But even *that* is unsure.

Many planners have faced the same frantic calls as we from clients whose finances have been left in ruins by Madoff's confession.

IMPACT:

a. Individual investors

The stories people are sharing are heart-breaking. There are so many families who depended on Madoff completely. They counted on the 10% + annual return.

They planned their lives around the money he managed: taking care of loved ones, provided for aging parents, invested for college for their children, they made decisions to retire and so on – all based on accounts managed by Madoff. Now all of that is shattered.

Many Madoff clients have apparently lost their entire liquid net worth. Those stories are repeated and confirmed in the newspapers.

From The New York Times:

"*There are people who were very, very well off a few days ago who are now virtually destitute*," said Brad Friedman, a lawyer with the Milberg firm in Manhattan. "*They have nothing left but their apartments or homes – which they are going to have to sell to get money to live on.*"

"The name 'Madoff' has overnight gone from being revered to reviled in the Helfman family," Mr. Helfman (attorney Stephen Helfman from Miami – and someone I know), said on Friday. His grandmother, at 98, relied on her Madoff money to pay for round-the-clock care, he said, and his two children's college funds were wiped out."

Quotes from "For Investors, Trust Lost, and Money Too," by Diana B. Henriques and Alex Berenson, The New York Times (12/13/08).

From The Wall Street Journal:

"*I'm wiped out*, " said Sandra Mazke, Maxam's (Maxam Capital Management LLC) founder and chairman. The Darien, Conn., fund of hedge funds will have to close as a result of the losses, she said."

Richard Spring, a Boca Raton (where I live and work) resident and former securities analyst, says he had about $11 million – or 95% of his net worth – invested with Mr. Madoff. "*That's how much I believed in him*," Mr. Spring said.

Quotes from "Fund Fraud Hits Big Names," by Robert Frank, Peter Lattman, Dionne Searcey and Aaron Lucchetti, The Wall Street Journal (12/13/08).

Several clients have expressed similar fates. And as one pointed out, while these clients still own homes, who can they sell their properties to now? The real estate market was *already* depressed. Indeed, stories in the newspapers revealed that some investors have already put properties up for sale – including 4 condos on the grounds of the Breakers Hotel in Palm Beach which were supposedly listed for sale over the weekend.

SIPC THE ANSWER?

There is some hope that the Securities Investor Protection Corporation ("SIPC") will provide insurance coverage for investors. Several articles in the Wall Street Journal in particular (but other sources as well), indicated coverage might be available. "*SIPC covers some losses up to $500,000 per account in limited cases, but it's unclear the extent to which SIPC will cover the investment-adviser accounts.*" "Losses in Madoff Scandal Grow" by Peter Lattman and Aaron Lucchetti, The Wall Street Journal (12/15/08).

It is not clear if all investors in Madoff's firm would be covered by SIPC for losses, and it is also possible the SIPC lacks sufficient funds to even pay the claims (apparently there is only $1.5 billion in the fund). Let's hope for the sake of investors that they will at least have *some* recovery.

b. Charities

The impact on charities will also be wide-spread. Many charities are reporting substantial losses. Rumors abound as to the extent of damage to endowments at public charities. Supposedly a number of Jewish Federations, Yeshiva University and other endowments are taking substantial hits.

The impact of private foundations has also been reported. Sadly Elie Wiesel's Foundation for Humanity appears to have been a victim of Madoff – perhaps losing its entire endowment. And a charitable foundation funded by Carl Shapiro and his family has allegedly lost nearly $150 million.

Foundations funded by Mort Zuckerman, Steven Spielberg, N.J. Senator Frank Lautenberg and many others are also reportedly victims. As reported in "Jewish Charities Shut Down Following Madoff 'Ponzi Scheme" Wipeout" on Foxnews.com (12/15/08).

Two private foundation have already reportedly closed their doors, and we know that others are close behind. The Boston Globe reported that the Robert I. Lappin Charitable Foundation, a private foundation which financed trips for youth to Israel and supported educational and cultural services on the North Shore of Boston (where I grew up), closed its doors Friday. Apparently the foundation lost essentially 100% of its estimated $8 million endowment which was fully invested with Madoff. "Boston Donors Bilked Out of Millions" by Beth Healy and Steven Syre, Boston Globe (12/13/09).

Also, the Chais Family Foundation in California reportedly also closed its doors. The Chais foundation gave away about $12.5 million annually to charitable causes and supposedly had all of its assets invested with Madoff. Reported in "Jewish Charities Shut Down Following Madoff 'Ponzi Scheme" Wipeout" on Foxnews.com (12/15/08).

In addition to those that invested with Madoff, the impact of the collapse will hurt other charities as well. Some received substantial portions of their funding from him.

For example, the Gift of Life Bone Marrow Foundation, which has saved hundreds of lives with its bone-marrow matching program, received much of its funding from Madoff and his Wall Street friends. The worthy services performed by it will need new backing. The Gift of Life Bone Marrow Foundation has already announced on its web site that it is seeking $1.8M of new funding. It is certainly not alone.

c. Hedge funds

Madoff's firm's collapse may also reverberate in the hedge fund world. Although it was not a hedge fund, per se, Madoff worked in a world of secrecy. While apparently offering transparency, no one knew *how* Madoff made money. His program was analogized to "working in a black box" - like many hedge funds. And nobody, it seems, really knew *what* was going on. The stories are replete (now) with advisors saying they never trusted Madoff's performance and his flimsy auditing firm that supposedly was made up of only one or two accountants. "Now Accused of Fraud, Wall St. Wizard Had His Skeptics," by Alex Berenson and Diana B. Henriques, The New York Times (12/13/08).

But those who invested with Madoff had no such understanding. On top of that, many hedge fund investors are going to find out their investments were wiped out due to the hedge funds' investments in Madoff.

Maxam Capital Management LLC reported a loss of $280 million on investor funds all held at Madoff and their founder says she will close the hedge fund's doors. GMAC LLC Chairman J. Ezra Merkin, a money manager with Ascot Partners LLC, reportedly held substantially all of the funds $1.8 billion under management at Madoff. In a letter Merkin sent to clients (and as reported in the Wall Street Journal), Merkin said he himself was one of Ascot's larges investors and he believed he personally had suffered major losses from this catastrophe. See "Fund Fraud Hits Big Names," by Robert Frank, Peter Lattman, Dionne Searcey and Aaron Lucchetti, The Wall Street Journal (12/13/08).

Other hedge funds (and particularly funds of funds) apparently held huge portions of their investments with Madoff. Fairfield Greenwich Group said in a statement Friday that it is assessing its losses, but as of Novermber 1 it has about $7.5 billion in investments connected to Madoff's firm (supposedly about half its total assets). Id.

Further, what impact will this have on hedge funds that *didn't* invest in Madoff? This scandal could lead to calls for more scrutiny of hedge fund managers. Perhaps even a cry for government regulation of an industry that is largely unregulated.

In a New York Times article, the following was noted:

"Mr. Madoff's case could hardly have come at a worse time for hedge funds. The whipsawing markets and suddenly unfriendly lenders have already taken their toll on high financiers, and many have already suffered what amounts to runs on the bank by investors clamoring to withdraw their investments."

"It can't help but have the effect of further chipping away at the confidence that the investor community has in the hedge fund industry," said Ralph L. Schlosstein, the chief executive of Highview Investment Group, a money management firm and a former president of BlackRock. *"But like many things that come at moments of fragility, its impact is magnified."* ...

The losses from the Madoff firm will also raise more questions about how well funds of funds perform due diligence, a concern already magnified by losses in the hedge fund industry.

Already under heightened scrutiny, the collapse of the Madoff firm is likely to propel calls for greater regulation of the hedge fund industry, beyond the current optional registration with the Securities and Exchange Commission. See "Hedge Funds Are Victims, Raising Further Questions," by Michael J. de la Merced, The New York Times (12/13/08).

d. Tax Issues:

A major issue for advisors to consider over the coming next several months will be the ability to claim a tax benefit from these losses. There is some precedent for claiming a loss like this as a *theft* loss, which can be deducted as an itemized deduction to the extent that the loss exceeds 10% of adjusted gross income (and further subject to a $100 "deductible amount" and the other rules on itemized deductions). Excess theft losses may be carried back three years.

The big issue is frequently not IF such a loss can be deducted, but WHEN. It may be months before investors know if they have suffered a *total* loss, *if* there is SIPC coverage, if the Receiver will obtain funds that can be distributed, etc.

Those answers may or may not be known by the time that tax returns are filed in 2009. If a taxpayer wanted to use the loss to carry-back to 2005, then the loss must be claimed by 2008. If that is the case, then the taxpayer must be able to prove a *total* loss by theft.

Some have suggested that a client might be able to "waive" rights to recover in order to take the loss in 2008, but the mechanics of doing so, let alone the legal aspects, remain subject to question.

More likely than not, it could be well after the 2008 due date when things are worked out. Taxpayers will need to decide whether to take a position on the 2008 return and risk tax, penalties and interest if a different loss year is established in the future, or whether to not claim the loss in 2008 and amend if need be in the future.

According to an article in the Wall Street Journal, some CPAs are talking about filing amended returns for the past several (3) years for clients who reported income from their Madoff accounts that obviously never existed.

There will surely be much more discussion over the coming months as to the best tax maneuvers to deal with the demise of the Madoff firm.

Also, over the past several years, some clients of Madoff received actual cash returns from the firm - whether in the form of distributions of current returns or account withdrawals. They too cannot sleep well at night right now.

It is unclear whether and to what extent the receiver for Madoff Securities will seek *repayment* of distributions. The federal bankruptcy court overseeing the $400 million scam by the Bayou Group LLC (remember when $400 million seemed like a big deal?) determined that under the law of "fraudulent transfer", the trustee could go back several years and reclaim distributions for the total Madoff investor group. This is one of the many legal issues that will be further developed in the coming months.

LESSONS LEARNED:

As I've said, what makes the Madoff case unique is the totality of the harm caused. So many of Madoff's investors became convinced of his superior stock-picking programs and forgot basic life lessons, like "Diversification matters". Many made their fortunes with him and continued to invest their entire portfolios with him. In fact, part of Madoff's scheme seems to have been having clients invest a little at a time and then gaining their trust and slowly but surely gathering their entire portfolios. He assured clients of steady, positive returns, and they reaped the benefits for 20+ years watching their Madoff securities portfolios increase many-fold in "paper" value. Compounding at 12-15% per year (and often more), we all know money grows rapidly.

But Madoff's scheme – now exposed – reminds us of lessons we learned (or should have learned) as children. We all recall parents saying something akin to:

- **If something *sounds* too good to be true, it probably *is*.**
- **Slow and steady wins the race.**
- **There's no such thing as a free lunch.**
- **Don't put all your eggs in one basket.**

If only we had a "wayback" machine (a time machine like Mr. Peabody, the dog in the television animated series Rock and Bullwinkle, used to help make things happen the way they were supposed to) which would allow us to travel back and remind ourselves and Madoff's investors of these tenets before making the mistake of entrusting too much to this charlatan and swindler……

The harm caused is so complete, that even those *un*involved (as I consider my firm and myself) can't help but feel a touch of guilt. While we do not offer financial advice and have no liability for investment choices made by clients; nevertheless, there is a sense of "what if" that you can't help but feel. What if we just pushed harder on the basic value of diversification?

It is not that we had a duty to do it, but looking back one cannot help but wonder what might have helped.

Yes, the demise of Madoff investments impacts many and will be a subject of much scrutiny over the coming weeks, months and maybe even years. But the impact on those harmed may be impervious to remedy. The clients don't own a security that might one day again appreciate. They hold a worthless statement from a massive fraud.

We can only hope that some of the money will be recouped and some of the innocent investors will be repaid.

What a shame.

HOPE THIS HELPS YOU HELP OTHERS STAY OUT OF HARM'S WAY!

Jeff Baskies

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http://www.boston.com/business/ticker/2008/12/massmutual_enti.html?p1=Well_MostPop_Emailed1