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Created 12/16/2008 - 6:52pm

Even investors who think they're safe are wrong.

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Let's say, just for the sake of argument, that you invested your life savings in a fund run by a Wall Street legend named Mr. Made Up. For 15 years, your investment in the Made Up Fund has risen a nice 10 percent a year, and now the \$1 million you put in is worth about \$4 million. Then you get a tip from a friend out on the golf course that the Made Up Fund is ... well, just what its name suggests.

Do you:

- a) *Take your money out the next morning, then go to the police*
- b) *Take your money out the next morning and say nothing*
- c) *Do nothing with your money and go to the cops the next morning*
- d) *Do nothing, say nothing, and hope that no one else notices*

The ordinary human impulse on finding out that you've given your money to someone who's unlikely to return it is to ask for it back immediately. The ordinary *moral* impulse is to let other people know. And the one choice that you'd think any reasonable person would avoid is (d). That seems completely obvious, right?

Unless, that is, you have any familiarity with the terrifying labyrinth of the law on investment frauds. Once you do, you'll see why even the investors who got suspicious of what Bernard Madoff was up to might have been very, very wary of going public—and why the Madoff implosion will probably lead to an even longer, uglier unraveling than the sheer numbers suggest.

A hedge-fund manager friend called last night to talk about Madoff. He wanted to talk about just how ugly the unraveling of the Madoff saga was likely to get. And if the first name on his lips was (obviously) Madoff, the second was Bayou. Bayou was a fund that blew up and was revealed in 2005 to be a fraud with some \$450 million in investor losses. Bayou is memorable for two reasons. One is founder Samuel Israel III's staged suicide. (He eventually rose from the dead and turned himself in after prosecutors went after the girlfriend who helped him disappear.) The other is a legal precedent set in the Bayou case that should scare the heck out of anyone who once invested with Madoff but who managed to get out safely in the last few years: Any investors who managed to take out profits from a fund like Bayou before the fraud was revealed *had to give the money back*.

On the face of it, the Bayou ruling (which stories in the *Wall Street Journal* and *Forbes* have, to their credit, noted) seems reasonable: If some early investors made outsized gains, doesn't it make sense for them to pay back the money to those who lost everything? But, as this fund-manager friend pointed out, it has some pretty extreme implications.

The obvious consequence of Bayou is that a country-club friend who'd given his money to Madoff and then gotten suspicious can't just take his money out and then go to the cops. If he reports his suspicions, he's likely to be asked to repay any of those 10-percent-a-year "profits" he'd accumulated for a decade. This is bad enough. But there's more to it here.

Much of the money that Madoff managed came from people who'd written a check not to Madoff directly but to so-called "funds-of-funds": hedge funds that had raised money from investors. A few of these funds-of-funds, such as Fairfield Sentry and Tremont Group's Rye Investment, had billions of dollars invested with Madoff and teams of auditors to track it. These companies should have wised up to what was going on much earlier.

Thanks to the Bayou court decisions, however, the moment Madoff was revealed as a fraud, any money that these funds-of-funds would have managed to take back would become gains that have to be given back to be redistributed among all the losers in the Madoff scheme. Now, this sounds bad enough, but ... again, there's more. There's no time limit on the gains they'd have to give back, so any fund that outed Madoff could be on the hook for any profits it had gained from its Madoff investments for years back. So, as my fund-manager friend puts it, "The question people have to ask is not, 'Do I have money in a fund that has exposure to Madoff *now*?' but, 'Do I have money in a fund that that has *ever* invested with Madoff?' "

At this point, the complexity of the situation should be clear. But maybe not the whole potential for absurdity. Imagine that Rich Folks Capital Management—RFCM—placed its money with Madoff 10 years ago and then decided, five years ago, that something didn't feel right and pulled it out. Well, now RFCM is on the hook for any of its gains from the time before the fraud was discovered. But what happens if the people who'd invested with RFCM 10 years ago aren't the same as the people who invest with it now? Tough noogies. RFCM's *current investors* are probably responsible for paying back gains in the RFCM fund that they never even saw. Or, possibly, RFCM needs to go after its own former investors. No one's really sure.

The technical Wall Street term for this is a *nightmare*. The Bayou precedent means that the discovery of a huge fraud leads to a whole chain of liabilities that stretches back for years and may hit investors who hadn't dealt with Madoff in a decade. A few folks who think that they've lost everything may, at the end of the process, get back some portion of their money. But many others who thought they'd escaped, or didn't even know they had any link to Madoff, will turn out to have huge losses.

All of which finally brings us back to the multiple-choice question we got started with. What would *you* do if you found you'd been taken in by a scheme like the one that Madoff seems to have organized? The fallout from the Madoff fraud for fund managers like Tremont and Fairfield already reaches into the billions of dollars. But that's not the end of the line. Even if the funds lose all the money that they had invested with Madoff when the fraud is revealed, they could still be on the hook for any money they'd taken out in earlier years. The managers—and the parent companies, such as Oppenheimer Funds, which owns Tremont—are likely to be asked to give back any money they thought they earned for their "success" in earlier years. Meanwhile, any funds that did manage to pull their money quietly out of Bernard Madoff's safe before the scam blew up could see their current and even *future* investors facing demands to give it back.

Your head just spins, doesn't it?

The bottom line is that the perfectly reasonable precedent set by Bayou—that investors who got out early shouldn't see profits from a Ponzi scheme—leads to a virtually infinite entanglement of give-backs and unravelings. The losses in a scheme like Madoff's do not simply stay where they seemed to lie at the end of the game: They have to be traced back through years of investments and redemptions.

The consequence of this is that any longtime Madoff investors who'd gotten suspicious could very well have seen that publicizing their suspicions and outing Madoff's scam would not have saved their money but actually exposed them to greater losses. As the law stands, post-Bayou, a major fund company that finds itself entangled in a scam like Madoff's has every incentive not to out the fraud but, rather, to keep its fingers crossed and maybe hope that the whole thing can be written off as just another multibillion-dollar stock market blowup. Now that the scam's been revealed, for Madoff, it's the end. But for the grand saga of litigation that will pit Madoff's hapless investors against each other and probably make Charles Dickens' *Jarndyce vs. Jarndyce* look like days in small-claims court, this is just the beginning.

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Mark Gimein also covered the Madoff story [when it first made news](http://www.thebigmoney.com/articles/judgments/2008/12/12/madoff-dilemma), saying that we should have known better than to trust consistent returns. Anne Applebaum said Madoff's breach of trust [will cripple American capitalism](http://www.thebigmoney.com/articles/judgments/2008/12/16/breach-trust). Trevor Felix [memorialized Madoff's victims](http://www.thebigmoney.com/features/loleconz/2008/12/15/madoff-victim-plz-help) in LOLEconz.

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