

Investing With Bernie Madoff: How It Happened,

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Global Research, January 23, 2009

23 January 2009

Region: [USA](#)

Theme: [Global Economy](#)

What Happened, And What Might Be Done.

I turn now from preliminary comments to specific courses of action. As you will see, each course of action being generally discussed in the media today will be insufficient, will be too little, too late, especially because the law is not designed to handle a disaster of this magnitude.

There is, first, the Security Investors Protection Act, commonly referred to as SIPC (pronounced Sipic). Under this Act investors can receive up to \$500,000. But, if they have taken money out of Madoff, this might be subtracted from the amount they receive — it is not yet completely clear how SIPC intends to handle this question, although one major straw in the wind could be that the head of SIPC told Congress that SIPC would reasonably quickly pay people who could show they never took money out of Madoff. However, SIPC will not cover persons who invested through a fund, rather than directly with Madoff. (One person has filed a petition requesting that this limitation be dropped.) SIPC covers only a portion of people's losses, even small people. And if SIPC subtracts from the \$500,000 the amounts that a person has taken out of Madoff, it is likely that those who are most desperate will get nothing: those who were living off what they thought were their earnings from Madoff — e.g., older people — have been taking money out every year, and likely would get no money from SIPC.

Then there is the possibility of recovery from the Trustee in Bankruptcy, who has taken over Madoff's business and estate, is seeking hidden monies, and will divide proceeds among the investors. A problem here is that it is widely thought that the Trustee is not going to uncover much money, at least not in comparison to the amounts investors are owed. So investors will get little back from the Trustee.

Another problem here is the so-called clawback problem. The media, and lawyers whom it quotes for reflexive positions representing the conventional wisdom, say that people who took money out of Madoff during the last six years will have to give back that money — this is the so-called clawback. This is terrifying to people, and, rightly so. Having been wiped out, or having suffered a huge loss that leaves one with only a small percentage of what one had, people now face the prospect of being obligated to give back six years of withdrawals — often withdrawals they needed to live, as with older people, or for perfectly reasonable purposes like buying a house. However, what is given much less media play is that, as I read the leading case in the field, clawbacks, in part at least, will not apply to people who had no inkling that anything was wrong — as true of so many of Madoff's victims. It applies only to people who took out money after learning of facts that reasonably should have put them on notice that something was wrong (and it would apply, I assume, though I haven't read anything explicit on this, only to money they took out after being put on such notice). And

finally, clawbacks will not apply, I believe, to the extent that money innocently taken out, with no knowledge of possible illegality, did not exceed the principal put in.

It is, of course, in a way quite perverse to claw back money from people who took out their money after they learned that something could conceivably be wrong. For taking out their money then, as I think one pension plan actually did if I remember correctly, is exactly what one would expect and hope they would do. What else should they have done — left their money in if they believed it was being stolen? Of course, it is possible that they should have gone to the SEC but didn't, and there are theories under which this could also make them liable to others, but leaving their money in to be stolen by Madoff hardly seems what a capitalist system expects from people.

Whether the Trustee in Bankruptcy is going to insist on clawbacks, at least from those who were not completely innocent of knowledge that something unlawful was happening, is unknown. But people remain terrified of the possibility, and as the media has said, many who innocently took out monies are considering not making claims either to SIPC or the Trustee lest their withdrawals come to these parties' attention when otherwise they might not due to the abominable condition of Madoff's records. Victims of Madoff are understandably terrified of being denuded of their few remaining assets, if any.

Then there are tax refunds. Persons who took supposed earnings (shown by their monthly statements) out of Madoff — to live, for example, or to buy a house — paid income taxes on that money at the rates applied to ordinary income — roughly a bit more than one-third the supposed earnings. They can get refunds of their last three years of taxes (2005, 2006 and 2007), and of estimated taxes already paid on the supposed Madoff earnings in 2008. But this will amount to only a fraction of the total income taxes many of them paid on supposed Madoff income (called phantom income) over the years — over 20 or 30 years of investing with Madoff.

You know, if these people had been committing tax fraud on the government for the 20 or 25 years, so that the government never got the tax it was entitled to, the government could go back and collect the taxes — with interest — for the full period of 20 or 25 years. But when the government, for 20 or 25 years, got taxes it was not entitled to because the tax was paid on phantom income, and when the horrible dereliction of a government agency is heavily responsible for the people thinking they had real income and paying taxes on it to the government, the people get refunds for only three years. The government can get all 20 or 25 years, the people can get only three years. This does not seem fair, and still less so in the context of governmental dereliction. If you ask me, there should be a special law allowing Madoff victims who paid taxes on phantom income to the government — taxes which would not have been paid but for governmental dereliction — to recover all the taxes they paid on phantom income. This would go some way towards easing the financial problem — the problem of how to live — of many Madoff victims, especially those who have been economically devastated. Refunds of income tax will not, however help all investors. In particular, charities and pension plans that were crippled or wiped out are nonprofit, tax-free organizations. So they never paid income tax, and will get no refunds of tax. Neither will people whose IRA monies were in Madoff, because they too paid no taxes on supposed earnings from Madoff.

There is also another tax consequence besides refunds for people who paid income tax on phantom income. There is a theft deduction for the amount lost by fraud. The deduction can

be taken against income in 2008, when the theft was discovered, can be used against (can be “carried back” against) the three prior years’ income (2005, 2006, and 2007), and can be carried forward for 20 years.

But there are huge problems with the theft deduction. The exact amount of the deduction that can be taken is a matter of great dispute, involving complex tax ideas that are incomprehensible to laymen and even to attorneys who are not tax lawyers. As is proverbial in other tax areas, if you put ten tax accountants and tax lawyers in a room, you might get ten different answers as to how much can be taken as a theft deduction. And the IRS may fight to keep the theft deduction as low as possible.

Then too, while the theft deduction has to be declared by an individual in 2008, the year in which the theft was discovered, the government may not allow it to actually be used for years — conceivably for five or ten years or even more. For it cannot be used until the exact amount of the theft loss is known with pretty fair certainty. But if one claims money from SIPC, or engages in litigation to try to recover money — as I would bet most will — then the IRS can claim that the amount of the theft loss is uncertain while the SIPC claim or the litigation claims hang fire, and the theft loss will be unusable until the SIPC and litigation proceedings are finished, which is likely to take years.

The theft loss deduction is also of no use to the charities or pension plans which got crippled or wiped out. For, as said, they are tax free nonprofits. They therefore pay no income taxes, have no past, present or future tax payments against which to deduct theft losses, and will obtain no benefit from any theft loss deductions. Ditto those who invested through IRAs.

This brings me to the question of lawsuits, several of which have already been filed.

Let me start with the question of suing the SEC. (One such suit has already been filed.) The “smart money,” the lawyers whom the media quote, reflexively provide the conventional wisdom that this cannot be done — the government is immune from suit, the SEC was exercising permissible discretion, etcetera, etcetera. Well, I’m not at all sure that the conventional wisdom is right in this case. In fact, I think it may be quite wrong, and that there are at least three theories on which the government could well be liable to investors for their losses. I don’t intend to get into those theories or the ideas underlying them here, except to make a general comment.

To wit: we have here a situation in which the SEC acted in gross violation of the public policy that the agency has been obligated to uphold since it was created in, I think, 1933. It is obligated, it has a duty to all citizens, to prevent fraud upon them. It has no discretion — none — to fail to follow up, with serious investigations, when presented with knowledgeable, detailed, obviously highly competent, and in many respects easily “checkable” allegations of the most serious fraud, of a huge fraud that is fooling thousands of people, stealing billions of dollars, and causing horrible injustice. It has no discretion, none, to thwart in such manner the basic purpose of the statute, the basic policy the statute established, the will of Congress, and the SEC’s own *raison d’être*. The SEC’s incredible willful negligence, its *de facto* (or, who knows, maybe even *de jure*?) complicity do, I think, make it liable to suit in this case under several different theories, even if it is not liable in other cases involving much different facts.

Then there is the possibility of suit against FINRA. Unlike the SEC, FINRA is not a governmental organization, but a private one. Thus arguments from conventional wisdom as

to why it's not possible to sue the SEC do not even apply against FINRA, as far as I can see. FINRA and its predecessors, particularly the NASD, appear to have been as incredibly negligent as the SEC, and will be sued once people learn of the inspections and negligence in the Madoff matter of FINRA and its predecessor, the NASD (both headed by Mary Schapiro, who now will head the SEC).

A major reason FINRA will surely be sued is that, if I understand correctly — and I think I do but would surely like to be told if I am wrong — (i) FINRA is a membership organization whose members comprise pretty much the entire brokerage community in the United States, including, probably, at least several of the huge, now bailed out investment banking houses because they usually had brokerage arms (e.g., Merrill Lynch) or even were mainly brokerage houses, and (ii) FINRA may well have the capacity (as does the SIPC) to assess its membership for money. If these assumptions are correct, virtually the entire brokerage industry in the United States, including vast bailed-out houses, all of whom could be assessed by FINRA, could be on the hook financially due to FINRA's incredible negligence in inspecting Madoff. FINRA would thus represent a very deep pocket capable of paying all the losses of investors in Madoff. It would, of course, be only poetic justice for the losses to be paid by the brokerage/investment banking community, since that community is so fundamentally responsible in so many ways for the country's entire financial meltdown — which, by the way, is also thought to have triggered the redemption requests made to Madoff by funds, requests that are in turn thought to have triggered Madoff's meltdown.

There also will be litigation against huge funds and banks that gave Madoff billions of dollars without doing due diligence, which they surely did have the money and knowledge to do or to have done for them, and which other large funds and banks here and abroad did do (and therefore decided not to invest in Madoff). These funds and banks had and failed in a duty of diligence owed to their investors, whose money they put in Madoff, and they will be sued by their investors. It is commonly thought that they had no duty to, and therefore cannot be sued by, persons who invested directly in Madoff rather than through a fund. I think there is a theory which such persons could use against the funds and banks, but I do not place a lot of stock in it.

(With regard to banks, there seem to be legitimate questions regarding Chase Bank. I have read that Madoff's sole account was with that bank. Chase never had reason to question transactions in the account, did it, e.g., large checks being sent to Swiss banks or to Lichtenstein or the Cayman Islands? I've also read that the wife of Frank DiPascali — who is Madoff's number two man and must certainly have been himself involved in the fraud — was an officer of Chase. She didn't supervise Madoff's account, did she? I have no reason to think Chase has any fault, but these questions must at least be asked, especially since these days nothing seems impossible.)

Then there is the question of suit against experts who ferreted out that something was rotten in the state of Madoff, who may even have advised clients or their companies not to put money in or deal with Madoff, and who did not bring to the SEC their suspicions and the well taken reasons for them. Can these people be liable because, if they, in what appear to be their possibly significant numbers, had informed the SEC of their suspicions, as did Markopolos, perhaps there would have been enough complaints to move the SEC off the dime? Well, I think it would be true in fact that complaints from all these people could have created a critical mass that would have had an impact, but for several reasons I would not bet my last farthing, or maybe even my first one, that suits against them would be successful.*

TO BE CONTINUED.

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