The New Madoff Windfall

By Edward Jay Epstein *Tue, Jan 25, 2011*

Our occasional columnist explains why hedge funds are scooping up discounted claims against jailed Ponzi artist Bernard Madoff.

Bernard Madoff's investors are now likely to get back most of the money they sank into his Ponzi scheme.

Indeed, given the favorable tax treatment they will receive, many of his investors will outperform those unfortunates who held legitimate stock market portfolios in the crash of October 2008. Meanwhile, Fortress Investment Group and other savvy hedge funds are now scrambling to buy up Madoff-related losses for as little as 61 cents on the dollar.

Madoff's fraud is providing opportunities for hedge funds because his court-appointed bankruptcy trustee, Irving H. Picard, with help from federal prosecutors and the Securities and Exchange Commission, has been able to collect $7.2 billion from the estate of Madoff's alleged accomplice, Jeffrey Picower.

Picower, who died in his Florida swimming pool on October 25, 2009, had been, according to the complaints filed by the trustee, so deeply involved in the scheme that Madoff advised him in advance of his monthly profit "targets," or the amounts that Madoff planned to pay into Picower's accounts. Picower could also request higher or lower "profits" for his many accounts.

Moreover, to amplify Picower's fictional profits, and allow him to siphon off billions, Madoff extended him so much notional ledger credit that Picower's accounts had, according to the bankruptcy trustee's analysis, a "negative net cash balance of approximately $6 billion at the time of Madoff's arrest."

Picower clearly collaborated in manufacturing his spectacular, if fictitious, profits by faxing Madoff back-dated letters to support fabricated trades. In some of the faked trades, Picower's reported gains ran as high as 550%. Picower's funds were frozen before his death, and his wife Barbara Picower and other relatives controlling the Picower estate faced years of litigation, if not prosecution by Federal authorities, if they did not settle with the trustee.

The estate came up with the $7.2 billion it needed to settle through a lucky break. When it was frozen, a large part of Picower's $5 billion account at Goldman Sachs was invested in Apple stock. Over the next two years, that stock nearly tripled in value. So the estate had not only enough money to settle, but over a billion dollars extra.

The trustee also applied pressure to the families of two other Madoff collaborators: Carl Shapiro, who was 97 years old and infirm, and Stanley Chais, who died of a blood disease on September 26, 2010. Shapiro's family agreed to repay $625 million. Chais' estate is expected to surrender over $1 billion (currently frozen).

Hedge funds like Fortress are betting that this $9 billion fund, together with additional monies that the trustee squeezed out of the feeder funds and banks that profited from the Madoff Ponzi scheme, will enable investors (and purchasers of investors’ losses) to recover at least 70 cents on the dollar. If so, the final irony of the Madoff fraud may be that it will provide a windfall for the hedge funds that bought up his losses at a steep discount.