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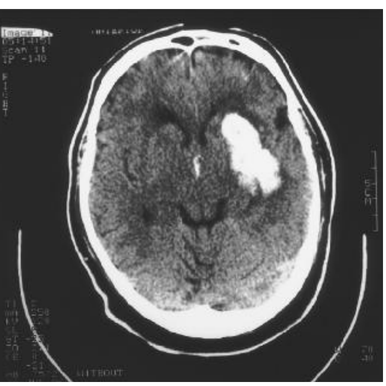
LITIGATION AND VALUATION ADVISER

In This Issue…

A CAT Scan of the Madoff Scandal

Diagnosing Fraud Inside the Black Box



While many investors may think the Bernard Madoff scheme is unprecedented, rest assured it is not. Daily headlines are now revealing fresh examples. The alleged fraud in the Madoff scheme has set a new and shocking dollar bar, but the financial and operational elements that are the recipe for such a disaster have been around for quite a while and we will likely see more such events in the future.

The investor's desire for "above average" returns, along with the elite lure of a private, exclusive investment realm, have resulted in an atmosphere ripe for fraudulent practices. Due diligence, audit statements, and understanding of investment strategy – traditional tools of prudent investors – often have been cast aside in recent years. Instead, whispered social relationships accompanied by regular reports of fund success and individual wealth building were the key attributes of many "sophisticated investors".

This article is for investors, advisers and lawyers on the phenomenon of hedge funds and other similar Unregulated Multi-Level Investment Structures ("UMLIS"). The intent is to illuminate the investment pitfalls inherent in this nearly impenetrable area of investment and what steps can be taken to prudently take advantage of the opportunities as the market is redefined.

The Typical UMLIS Structure

The typical organizational chart of a domestic hedge fund (*see Figure 1 on page 2)* is composed of a related group of entities whose objective is to manage the pool of contributions that investors make to the fund. We can begin to quickly appreciate the multiplicity of roles that go into making up such an investment vehicle.

While it is common to refer to the entire entity as a fund, in most cases the actual fund is a separate partnership whose sole assets are the investments themselves.

(continued on page 2)

From Marty…

In the spring of 2008, although a bit cocky while enjoying the epicurean delights of new restaurant openings and the great cupcakes at the Magnolia Bakery on 72nd Street, I spoke of the sobering event of the Bear Stearns crash.

Summer gave us warnings, the Fall said it is here, but perhaps we could not believe it till Bernie Madoff reminded us of how misguided we have been in our zeal to accumulate wealth over the last decade.

I thought we would share with you an in-depth article that takes a "CAT scan" of the alleged Madoff scheme. In the post December 11th announcement, Bernie has been joined by several other alleged Ponzi masters in

(continued on page 3)

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CAT Scan of Madoff

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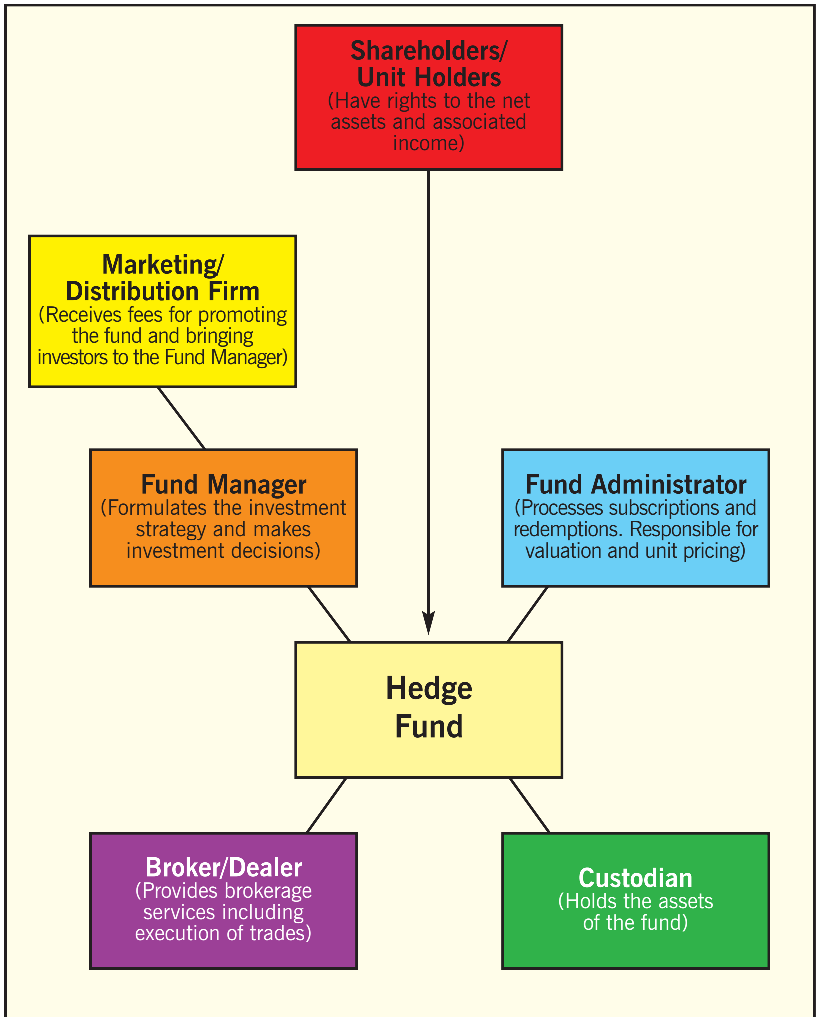

Figure 1: Structure of a Typical Domestic Hedge Fund

In appearance, hedge funds resemble the more generally familiar mutual funds in that money can be invested in a wide range of investments through a common group, and where the cost of doing so is shared. However, there are several critical differences investors need to be aware of before considering a hedge fund or UMLIS investment.

The most important distinction between a UMLIS and a mutual fund is that the latter is regulated by both federal and even state governments and therefore operates within the narrower confines of a statutory framework. Mutual funds have trustees and/or boards of directors charged with the safeguarding of assets and the compliance with all of the relevant regulations. A hedge fund or UMLIS relies on its own internal rules and values without official watchdogs.

In the world of the UMLIS, investments are more complex, fast-moving and carry great risk. The potential of all this dynamic action is greater investor reward. But the investing takes place outside of the more universally understood rules of the road. On the UMLIS superhighway there are often no speed limits, no lane dividers, no police radar and the exits are not clearly posted.

Now, look at the charts in Figure 2 (*page 4*), which illustrate the challenge in tracing an investor's original investment as it gets pooled, sliced and diced into a fund of funds and then commingled with other investor's contributions as the feeder fund wires the aggregated amount to the fund that actually executes the proprietary investment strategy (e.g. hedges, derivatives or options) through a broker/dealer, i.e., the Prime Broker.

(For an expanded view of Figure 2, visit
http://www.holtzrubenstein.com/090203_charts.pdf)

As you examine Figure 2, consider all the distinct entities that may exist between the investor at the top and broker dealers at the bottom. With so many separate moving parts it is easy to see how difficult it can be to fully understand the route investment dollars travel.

Auditors who usually are relied upon to verify results and the correctness of operations have limited perspectives when examining UMLIS structures because their responsibility is only for the particular entity for which they are engaged. In most cases, there are different accounting firms at each level, as (we are now discovering) was the case in the Madoff operation.

Whether by design or consequence, the UMLIS structure obscures the view of the complete picture by avoiding a comprehensive look at the entire process.

The Madoff Fund Structure and the Mystery of the 17th Floor

In Figure 2 we also see an approximation of the outlines of the Madoff organization. The actual entity structure used by Madoff is not yet fully known. We do know Bernard L. Madoff Investment Services LLC ("BLMIS") was a market-maker business and a licensed broker/dealer subject to SEC and Financial Industry Regulatory Authority ("FINRA") oversight. It was one of the largest brokers on the NASDAQ Stock Exchange, of which Madoff was once chairman.

(continued on page 4)

From Marty

(continued from page 1)

Long Island, Pennsylvania and Florida. We take you through the exposure areas in which investors in unregulated multi-level investment structures ("UMLIS") place themselves.

Understanding the risk for fraud, Joe Koletar and I talk about how our integrated approach to due diligence can make the difference and why many successful hedge and UMLIS funds avoided being caught in the scheme.

The full version of this article can be found on our website at: http://www.holtzrubenstein.com/Catscan.pdf.

Our website also shows some great accompanying flow charts of the probable entity structure and information flow of an investment in the Madoff fund.

Looking forward to better times, we've also included – in our helpful statistics on page 7 – the world's most exclusive shopping streets.

As we wait for the market to rebound, the new administration to pump the economy, and Spring to bring blossoms to our fair city… peace and hope, my friends.

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CAT Scan of Madoff

(continued from page 3)

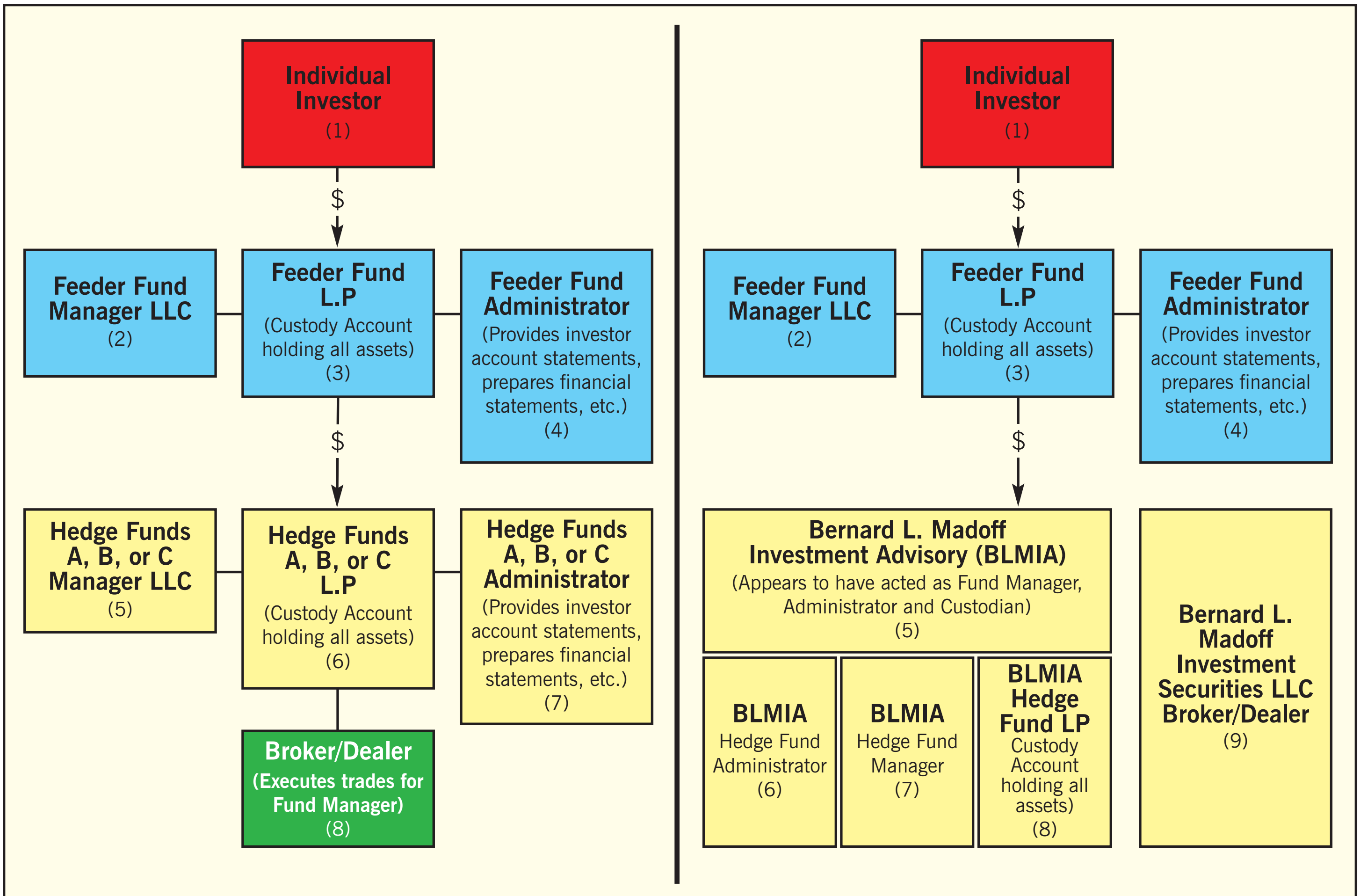

Figure 2: Typical Feeder Fund Structure vs. Possible Madoff Fund Structure

However, it is alleged that on the now infamous 17th floor, below BLMIS, Madoff operated an investment advisory business that oddly received no fees from BLMIS and was unregulated. By all appearances it was a black box, which domestic and international feeder funds and individual investors believed was a very successful hedge fund.

Madoff told investors his black box executed a “split-strike conversion” strategy to produce consistently positive results over many years. That was his story and he stuck to it.

The truth is, few people had any idea what really happened on the 17th floor. And few people tried to find out. The promise of robust returns even in down markets and the reputation of the Madoff firm and its founder, as well as the seduction of participating in a members-only investment club beyond the pale of inhibiting regulation, all contributed to an atmosphere ripe for fraudulent exploitation.

Warning signs were evident. Some analysts pointed out that the strategy of deftly using puts and calls against a basket of stocks was not sustainable on a regular basis or in some years was not even possible given market volume for such transactions. Still, these Cassandra concerns were masked by more powerful motives and were ignored even if known.

A New Due Diligence to Detect Fraud

Already clear is that the prevailing market attitude of willful naiveté and ignorance towards UMLIS will have to be replaced by a more alert and cautious approach that involves an in-depth examination of any entities that seek to attract big investors.

The actual details of the Madoff debacle will emerge only after painstaking forensic investigative and accounting work is done, to unravel the relationships between the Madoff black box and those who poured the money into it. Those details and the possible conflicts of interests they reveal will help drive new laws through Congress and regulations through government agencies. This will doubtless result in a new definition of what constitutes due diligence, especially with respect to UMLIS.

The outlines of that "new" due diligence already are well known to those intimately familiar with the investigation of complex financial organisms and the entrepreneurs who create them.

Among the UMLIS inquiries likely to be made by forensic investigators and compliance teams going forward are:

- Performance measurement over time with close comparison with industry data
- Disclosed investment strategy
- Skeptical review of "great" historical returns
- Examination of underlying assets under management and the models created to test outcomes
- Testing the quality of audited financials
- Basis for fund valuation
- Discovery of data otherwise available from a regulated entity
- Details of all fund investment agreements and other terms
- Review of fund's risk assessment

Yesterday, some investors and managers of feeder funds doubtless saw such comprehensive reviews as expense drags on the fees and profits coming their way from doing business with the Madoff machine. Today, those still in business may find such procedures the new cost of doing business.

An Integrated Approach – Due Diligence With Teeth

Nowadays, due diligence too often is comprised of Internet searches for litigation histories and business stories that might speak to reputation, combined perhaps with some off the shelf quantitative analysis. In some respects there is a "don't ask, don't tell" quality to the anemic efforts undertaken.

Investment firms will have to put veteran forensic experts in the field armed with skeptical attitudes, multiple investigative skill sets, and a willingness to knock on 17th floor doors to ask hard questions in person. Proprietary investment strategies, high rates of return, and the invention of new financial instruments all should be subject to challenge by professionals with the requisite backgrounds in mathematics, law enforcement, and forensic accounting. The need for such an aggressive, savvy approach can now be seen in a different light.

Achieving substantive reputational and financial due diligence results requires getting beyond marketing puffery, self-serving narratives and the veil of secrecy surrounding a fund's operation. This all can be accomplished in a professional manner while respecting confidentiality. As in any successful transaction, there must be trust on both sides.

Confronted with the decision on a treaty between the United States and Russia regarding the reduction of nuclear warheads, President Reagan famously said: "Trust, but verify." This same advice should guide those who take on the daunting responsibility of investing tens of millions of dollars, to avoid devastation and ruin for themselves and their clients. h

This is an abridged version of the full article which can be found at http://www.holtzrubenstein.com/Catscan.pdf*.*

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Valuations Should Assume Reasonably Prudent Management

In *Cox Enterprises, Inc. v. News-Journal Corporation*, the U.S. Court of Appeals for the Eleventh Circuit held that a going-concern valuation should assume that a business *"will be managed in a reasonably prudent manner going forward, regardless of how poorly it may have been run in the past."*

News-Journal Corporation (NJC) is a closely-held Florida corporation that publishes the *Daytona Beach News-Journal* and several shopping guides. Cox Enterprises (Cox) is a privately-held, Atlanta-based corporation that owns 17 daily newspapers throughout the Southeast and had owned a 47.5% interest in NJC. NJC's CEO and members of his family owned the remainder of its stock.

Under the guidance of its CEO, NJC provided millions of dollars in financial support to several not-for-profit cultural organizations. Upon learning of these activities, Cox sued NJC, alleging various acts of fraud, waste and mismanagement. Pursuant to Florida law, NJC elected to buy back Cox's shares at "fair value."

The parties were unable to agree on the fair value of the stock, so the federal district court held a bench trial to determine that value.

Trial court uses normalized earnings

Cox's expert valued its shares based on NJC's fair market value as a "going concern." He used a comparable sales analysis and also performed a discounted cash flow analysis as a check on his comparable sales approach.

In determining NJC's value, Cox's expert "normalized" NJC's 9.3% operating margin to 28.3%, which was the average operating margin of 11 publicly traded newspaper companies at the time. He estimated the company's value at $306 million, or $145.35 million for Cox's shares.

NJC's valuation expert relied exclusively on a discounted cash flow approach, but he assumed that NJC would maintain its historical operating margins going forward. Using this approach, he arrived at a value of $61.9 million, or $29.4 million for Cox's shares.

The district court adopted Cox's valuation approach. The court, however, found it more appropriate to normalize NJC's operating margin to the average of similar closely held newspapers (24.8%), rather than the 11 public companies the expert had used. Based on this approach, the court determined that the fair value of Cox's shares was $129.2 million.

11th Circuit agrees

On appeal, NJC challenged, among other things, the district court's interpretation of "going concern" and its normalization of NJC's earnings.

But the appellate court upheld the district court's approach, explaining that *"to apply a definition of 'going concern' which requires a valuation on the basis of any previous mismanagement or waste would provide an incentive for majority shareholder/directors to violate fiduciary duties and commit waste to drive down the value of minority shares."*

Thus, the appellate court found that normalizing NJC's earnings was appropriate.

Helpful Statistics

Treasury yields[1]
30 day: 0.03% | 5 year: 1.52% | 20 year: 3.18%

Prime lending rate[2]
52 Week High: 7.25% | 52 Week Low: 3.25%

Dow Jones 20 year bond yield[4]
8.12%

4th Quarter 2008 Returns by Sector[3]
Large-Cap Core: -21.99% Small-Cap Core: -25.95%
Mid-Cap Core: -25.09% Real Estate: -38.71%
International Large-Cap Core: -21.19%

Barron's intermediate grade bonds[4]
15.15%

High yield estimate[4]
Mean: 40.47% | Median: 30.98%

IBBOTSON: Total rate of return for years 1926–2007[9]
Small Cap: 12.5% | Large Cap: 10.4%

Dow Jones Industrials P/E Ratios[2]
On 2008 earnings: 18.28
On 2009 earnings estimate: 10.58

S&P 500 Index P/E Ratios[5]
On trailing 12-month earnings: 19.44
On 2008 EPS estimate: 18.31

U.S. Equity Indexes – YTD Returns[5]
S&P 500: -39.00% NASDAQ Composite: -42.10%
Dow Jones Industrials: -33.40% NYSE Composite: -42.50%
Dow Jones Transports: -23.20% Wilshire 5000: -39.60%
Dow Jones Utilities: -28.20%

Long-term inflation estimate[6]
2.5%

Unemployment
US: 7.2%[7] | NYC: 5.7%[8]

Average vacancy rates NYC[8]
Hotels: 13.6% | Office space: 5.4%

World's Most Exclusive Shopping Streets[10]
Avenue Montaigne. Paris, France
Bahnhofstrasse. Zurich, Switzerland
Madison Avenue. New York City
Neuer Wall. Hamburg, Germany
Via Monte Napoleone. Milan, Italy
Omotesando Street. Tokyo, Japan
Rodeo Drive. Beverly Hills, California
Worth Avenue. Palm Springs, Florida

1/Source: *Federal Reserve Statistical Release*; www.federalreserve.gov; December 2008 average
2/Source: *Wall Street Journal Online, www.wsjonline.com,* as of January 16, 2009
3/Source: *Barrons Online,* Fourth Quarter 2008 Results By Sector Quarterly Returns
4/Source: BV Resources.com; Business Valuation Update, January 2009; data as of December 1, 2008
5/Source: *The CPA Journal*, January 2009; data through November 28, 2008
6/Source: 10 year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, December 19, 2008
7/Source: United States Department of Labor; Statistics dated January 9, 2009; data for December 2008
8/Source: New York City Economic Development Corporation, *A Summary of New York City's Economy*; December 2008; rate as of October 2008
9/Source: Ibbotson/Morningstar, *SBBI Valuation Edition, 2008 Yearbook*; Total returns for 1926–2007, Table 2-1, Geometric Mean
10/Source: *www.TravelChannel.com*

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