Bernard L. Madoff Investment and Securities: A Focus on Auditors’ and Accountants’ Legal Liability

Synopsis During 2008, Bernie Madoff became famous for a Ponzi scheme that defrauded investors out of as much as $65 billion. To satisfy his clients’ expectations of earning returns greater than the market average, Madoff falsely asserted that he used an innovative “split-strike conversion strategy,” which provided the appearance that he was achieving extraordinary results. In reality, he was a fraudster. Madoff was arrested on December 11, 2008, and convicted in 2009 on 11 counts of fraud, perjury, and money laundering. As a result, Madoff was sentenced to 150 years in prison. Follow the Money The Securities Investor Protection Corporation (SIPC), which provides aid to customers of failed brokerage firms when assets are missing from customer ac- counts, gave Madoff’s victims $800 million and appointed Irving Picard as the trustee responsible for liquidating Madoff’s firm in December 2008. Picard filed claims totaling $100 billion in lawsuits against Madoff’s feed- er funds, banks that Picard believed to have aided Madoff in perpetrating his fraud, clients who took out more than they put in (“net winners”), and the Madoff family. In addition to the feeder funds coming under fire, the firms auditing these funds also became litigation targets.

Firms Auditing Feeder Funds

The first lawsuit against a feeder fund’s auditor was bought in December 2008. The lawsuit, brought by New York Law School and the limited partners of feeder fund Ascot Partners, was against the Ascot partners auditor BDO Seidman (and I. Ezra Merkin, the feeder fund’s general partner).

The lawsuit alleged that BDO Seidman was grossly negligent and failed to do the following:

Use due professional care; properly plan the audits; Maintain an appropriate degree of skepticism, and; Obtain sufficient competent evidential matter to support the conclusions of the audit reports. The lawsuit alleged that Ascot Partners had made materially false and misleading statements to investors, implying that it would use “numerous third-party managers with varying execution strategies, thereby avoiding the risk of concentrating capital in too few investments or managers.”2 Virtually all of Ascot’s $1.8 billion was invested with Madoff. A spokesman for BDO Seidman released the following statement: It is understandable that investors affected by the massive fraud at Bernard L. Madoff Investment Securities are frustrated and angry . . . BDO Seidman is not and has never been the auditor of Madoff Securities. BDO Seidman’s audits of Ascot Partners conformed to all professional standards and we will vigorously defend ourselves against these unfounded allegations.

Madoff ’s Auditor From 1991 through 2008, Bernard L. Madoff Investment and Securities’ (BLMIS) financial statements were audited by the accounting firm Friehling & Horowitz. In March 2009, David Friehling, who was a CPA licensed by the state of New York, was arrested and charged with securities fraud, aiding Madoff . The charges brought against Mr. Friehling include that he failed to do the following 4: Conduct independent verification of BLMIS revenues, assets, liabilities related to BLMIS client accounts, and the purchase and custody of securities by BLMIS; Test internal controls over areas such as the payment of invoices for corpo- rate expenses or the purchase of securities by BLMIS on behalf of its clients; Examine a bank account through which BLMIS client funds flowed. The SEC also filed a civil case against Mr. Friehling and his firm Friehling & Horowitz. The AICPA and the New York State Society of CPAs have since ex- pelled Friehling from membership. Under the AICPA’s peer review program, auditors are monitored through mandatory peer review every three years. Mr. Friehling’s work was not peer-reviewed because, since 1993, he had informed the AICPA that he did not perform audits, and therefore, would not need a peer review.5 Importantly, beginning January 1, 2012, New York firms with three or more accounting professionals must be peer-reviewed once every three years.6 On November 3, 2009, Mr. Friehling changed his plea from not guilty to guilty for the crimes involving the filing of falsely certified audits and financial statements with the SEC. “First and foremost, it is critical for Your Honor to be aware that at no time was I ever aware that Bernard Madoff was engaged in a Ponzi scheme,” said Friehling to the presiding judge in his case. Friehling made a point to mention that he and many members of his family had lost their retire- ment savings on account of having invested with Madoff.7 Although Friehling was initially supposed to be sentenced in 2010, the sentencing had been repeatedly postponed due to his cooperation with the government; as of June 2012, he had not been sentenced. However, Friehling lost his CPA license in July 2010. Several additional courts have also made decisions affirming that the auditors of the feeder funds could not be found guilty of fraud or malpractice. The decisions were appealed, but later upheld. Representative of the other major decisions in these cases, the appellate court upholding the dismissal of charg- es against KPMG and Ernst & Young (auditors for funds by Tremont Group

Case Questions

1. Refer to the fundamental principles governing an audit. Under the responsibilities principle, auditors are required to exercise due care and maintain professional skepticism throughout the audit. Based on the case information, discuss the ways in which the BLMIS auditor, David Friehling, disregarded his responsibility to uphold the fundamental principles governing an audit.

2. Consider the charges brought against the BLMIS auditor, David Friehling, regarding his failure to complete certain audit steps. If you were auditing BLMIS, what type of evidence would you like to review to determine whether BLMIS had (1) purchased, (2) sold, and (3) maintained proper custody of investment securities?

3. Consider an auditor’s common law liability to third parties. Describe the difference among the three levels of failure to exercise due care: ordinary negli- gence, gross negligence, and fraud. Based on the case information, comment on the possible level of failure that was seemingly exhibited by BDO Seid- man in their audit of Ascot Partners. Are there any factors that you believe could be used in defense of the auditing firm?

4. Consider Section 24 of the Securities Act of 1933 and Section 32 of the Securities Exchange Act of 1934. Based on the case information, do you be- lieve that the BLMIS auditor, Friehling, should be facing criminal charges? Why or why not? Next, do you believe that the Ascot Partners auditor, BDO Seidman, should be facing criminal charges? Why or why not?