IRALERT

April 27, 2011

TO: IRA Group Distribution

From:

Name	Email	Name	Email
Elizabeth T. Dold	etd@groom.com	Louis T. Mazawey	ltm@groom.com
Lars C. Golumbic	lcg@groom.com	David W. Powell	dwp@groom.com
David N. Levine	dnl@groom.com	Stephen M. Saxon	sms@groom.com
Richard K. Matta	rkm@groom.com	Roberta J. Ufford	rju@groom.com

RE: **Federal Court Relieves IRA Trustees of Liability for Madoff Investments**

A number of investors in Bernie Madoff's $18 billion Ponzi scheme were IRAs, which has had IRA custodians and trustees concerned with the extent of their possible responsibility for such investments. In a decision that the IRA industry generally should find helpful, the U.S. District Court for the District of Colorado recently dismissed numerous state and federal law claims by IRA account holders who asserted that the IRA trustees (and some of their affiliates) who administered the IRAs should be held responsible for losses incurred in connection with investments made with Madoff's brokerage firm. Mandelbaum v. Fiserv, Inc., No. 1:09-cv-01356 (D. Colo. Mar. 29, 2011). We highlight key aspects of the 40-page decision below.

Factual Background. The IRAs in question were self-directed IRAs, and as noted by the court, the account holders made all investment decisions. Pursuant to directions from the account holders, their funds were sent to Bernard Madoff's brokerage firm (interestingly, though not noted in the decision, an IRS-approved nonbank custodian for IRAs at the time) for investment in securities. Additionally, in accordance with the agreements underlying the IRAs (the "IRA Agreements"), the defendants provided no financial or investment advice, conducted no valuations or due diligence, and charged nominal annual fees to prepare tax paperwork and provide specified administrative services.

The IRA Agreements (excerpts from which are included in an Appendix to the court's decision) contained explicit provisions that indemnified the defendants from liability resulting from any claims arising from the accounts. The account holders nevertheless made a number of arguments seeking to impose some duty on the defendants.

Numerous Claims Rejected. Initially, the plaintiffs argued that the court should create federal common law in light of the IRA Agreements' reference to section 408 of the Internal Revenue Code of 1986, as amended (the "Code"). The court rejected this argument, stating:

- the Code does not create a private right of action against fiduciaries of IRAs;

- fiduciary duty claims generally fall under state law; and
- section 408 of the Code does not impose a specific duty on an IRA custodian to prevent an account holder from making unwise investment decisions or to exceed the duties set forth in the IRA Agreements.

The account holders also asserted that federal common law should be created because of inconsistencies between applicable federal and state statutes. The court disagreed, finding that the subject IRA Agreements are not employer sponsored, and therefore, not subject to ERISA; state law does not prevent the successful execution of the objectives of section 408 of the Code; and the account holders did not direct the court to any other federal authority which would conflict with state contract law. The account holders also alleged a breach of fiduciary duty under ERISA. However, the account holders lacked standing to sue under ERISA, because, as stated above, IRAs that are not employer-sponsored are not covered under ERISA (presumably, these were not SEP or SIMPLE IRAs).

The account holders made negligence claims based on the defendants' "extreme departures from the standards of ordinary care." However, no duties independent of the IRA Agreements were identified by the account holders, and the court found that any potential pre-existing duties were eliminated by very broad (and, in our experience, typical) exculpatory language of the IRA Agreements.

The account holders alleged breach of contract based upon defendants' failure to hold securities or other property in trust, to exercise control over and maintain the trust assets, to generally avoid commingling of the trust, and to furnish annual reports that accurately set forth asset valuations. The court stated that the defendants transferred assets to Madoff at the direction of the account holders, and had no duty to prevent the commingling of assets after such transfer. Additionally, the IRA Agreements specifically provided that defendants have no duty to conduct appraisals of investments or to verify any account statements received from a third party. For example, one agreement provides: "[Defendant] does not conduct appraisals of investments and it does not seek to verify any values reported to it." The court stated that the IRA Agreements were to be enforced in accordance with their express terms.

Although a party cannot generally recover for unjust enrichment where a contract covers the subject matter, the account holders also argued that they could recover in this case because their claims concerned extra-contractual benefits. The court rejected this argument and found that the account holders' contention that amounts received by defendants from Madoff, presumably through other business arrangements, came from investment assets of the account holders was too tenuous and vague to show that defendants directly received a benefit at the expense of the account holders.

Finally, the court agreed with the defendants that the state law claims of the account holders were barred by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").

Observations. Significantly, the court clearly stated that there is no private cause of action against fiduciaries under section 408 of the Code. However, as to the fiduciary, negligence and contract-based arguments, the court relied heavily on the terms of the IRA Agreements between the account holders and the defendants. While the court seems to fully

appreciate that IRA investments are under the sole control of the investor and that the typical IRA trustee is a fairly passive entity, one wonders whether the court might have reached a different result on some of the account holders' other claims had the IRA Agreements not contained such specific exculpatory language.

Another interesting issue is raised by the language of the IRA Agreements under which the trustees of the IRAs did not agree to value assets at their fair market value. Qualified non-bank custodians approved by the IRS must represent to the IRS that they can value the assets they hold, and the Internal Revenue Manual specifically mentions that as part of the steps in an audit of a nonbank custodian (and also notes that revocation of approval as a nonbank custodian can be a penalty for failure). The defendants in this case were not nonbank custodians, but were trust companies which made no such representation to the IRS. On the other hand, whether a nonbank custodian, bank or trust company, IRA custodians and trustees are required to report the fair market value of the IRA assets annually on Form 5498, and to report the value of distributions on Form 1099-R. Presumably, however, any failure in that regard is between the reporting entity and the IRS, and should not support a cause of action by the IRA owner (whose damages do not necessarily relate to any valuation failure in any event).

IRA custodians and trustees should be wary of over-reliance on this helpful decision. It is one district court decision based on specific facts and IRA language, and other courts might come to a different conclusion on one or more issues. Particularly for nonbank custodians, adherence to the specific requirements for valuation under IRS regulations, and the representations made to the IRS as part of process for approval to act as a custodian, would still seem to be prudent. IRA custodians and trustees also should review their IRA language and agreements to tighten duties and expand exculpatory language.

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Please feel free to direct questions to any of the Groom principals listed above or to IRA@groom.com.