Estimating JP Morgan Chase's Profits from the Madoff Deposits

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Abstract

JP Morgan Chase had deposits from Bernard L. Madoff's investors totaling $5.5 billion at one point in 2008. The Chase account was supposedly where most of the funds in his Ponzi scheme were deposited. Any large deposit can be a considerable source of profit to a bank. Assuming that the deposits returned the bank's net interest margin and grew at a random geometric rate, this paper estimates that JP Morgan Chase generated $435 million in after-tax profits from this very large account over the course of sixteen years. With JP Morgan Chase the target of pending lawsuits relating to the Madoff fraud, this paper's methodology and results may be of interest to litigants, prosecutors, journalists, and academics.

Journal of Economic Literature Codes: G01, G21, G24, K13, K14, K23, K41, K42

Keywords: deposits, fraud, JP Morgan Chase, litigation, Madoff, Monte Carlo simulation, net interest margin (NIM), Ponzi schemes, valuation

1. Introduction

Banks are in the primary business of taking deposits and lending out the proceeds of their deposits at higher interest rates to individuals and businesses. Any long-term large deposit for a bank can be very profitable. This paper estimates, based on court filings, that JP Morgan Chase earned after-tax profits for their shareholders totaling $435 million dollars from 1993 to 2008 from the billions of dollars deposited in the bank as part of the Madoff Ponzi scheme. Without detailed account records, these estimates should be treated with some caution. Nevertheless, with suits pending relating to the JP Morgan Chase account in the name of Bernard Madoff Investment Securities (BMIS), this paper indicates that JP Morgan Chase's shareholders may have profited in the short-run if Chase's bankers ignored warning signs about that account. Yet, the authors suspect that JP Morgan Chase's shareholders now wish that Madoff had put his deposits in a competitor's bank.

On June 29, 2009, Bernard L. Madoff was sentenced to 150 years in a medium-security federal prison for defrauding up to 2,330 investors out of $21.2 billion. Handing down the sentence, the district court judge called his theft "extraordinarily evil."[1] Mr. Madoff ran the largest Ponzi scheme in history. Ponzi schemes use the funds of new

[1] Diana B. Henriques, June 30, 2009, "Madoff Is Sentenced to 150 Years for Ponzi Scheme," *New York Times* accessed online on August 22, 2009, at http://www.nytimes.com/2009/06/30/business/30madoff.html.; Diana B. Henriques, July 10, 2009, "Claims Total Over 15,400 in Fraud by Madoff," *New York Times* accessed online on August 22, 2009, at http://www.nytimes.com/2009/07/10/business/10madoff.html.; Zachary Kouwe, July 15, 2009, "Madoff Arrives at Federal Prison in North Carolina," *New York Times* accessed online on August 22, 2009, at http://www.nytimes.com/2009/07/15/business/15madoff.html; A more famous $65 billion figure, which widely reported on when the fraud was discovered, includes the inflated account balances which included the compounding Mr. Madoff's fictitious returns. In a press conference on October 28, 2009, the Madoff Trustee Irving Picard, who oversees the bankruptcy estate of Mr. Madoff's business and is charged with deciding customer claims, said that 2,330 investors sustained losses of $21.2 billion. See "Madoff Cash Losses Climb to $21.2 Billion," *New York Times*, accessed online on December 28, 2009, at http://dealbook.blogs.nytimes.com/2009/10/28/madoff-cash-losses-climb-to-212-billion/.

investors to pay "returns" to old investors. Investor redemptions in the financial crisis of 2008 caused Mr. Madoff's scheme to unravel. In his allocution of his scheme, Mr. Madoff said, "For many years and up until I was arrested on December 11, 2008, I never invested those funds in securities, as I had promised. Instead, those funds were deposited in a bank account at Chase Manhattan Bank." Chase Manhattan Bank merged with JP Morgan in 2000 to become JP Morgan Chase.

By several accounts, this Chase bank account was active from 1992 to 2008. (If it were discovered that the Chase account was part of the Ponzi scheme for longer, our estimates would be larger.) The complaint by the Securities and Exchange Commission (SEC) against Madoff's alleged partner in crime, Bernard Madoff Investment Securities' former Chief Financial Officer Frank Dipascalli, Jr., puts the account balance of the Chase 703 checking account at $5.5 billion in 2008.[2] The JP Morgan Chase checking account was used to take client deposits and client redemptions. The market crash in September 2008 caused BMIS to receive redemption requests totaling over $6 billion, leading to Mr. Madoff's confession in December 2008. In his allocution before the court, Mr. Madoff said, "To the best of my recollection, my fraud began in the early 1990s. At that time, the country was in a recession and this posed a problem for investments in the securities markets."

That statement seems consistent with a start date earlier than 1992 since the National Bureau of Economic Research says that the early 1990s recession ended in

[2] Francesco Guerrera, August 12, 2009, "Probe Shines Spotlight on Pair of JPMorgan Accounts," *Financial Times*, accessed online on December 28, 2009, at http://www.ft.com/cms/s/0/ac179122-86d6-11de-9e8e-00144feabdc0.html.

March 1991.[3] Yet, a slow economic recovery in 1992 is often attributed to the defeat of President George H. Bush. The plaintiff's complaint in *MLSMK Investments Co. v. JP Morgan Chase*, which we will refer to as *MLSMK*, provides the timeline for the account as beginning in 1992 to Mr. Madoff's arrest in December 11, 2008. This is consistent with the timeline provided by the SEC complaint against Frank Dipascalli, Jr. In the fall of 1992, the SEC complaint alleges that some feeder funds, which recruited investors with high "guaranteed returns" to Mr. Madoff's investment company, were put into receivership because they were charged with unlawfully offering unregistered securities. Many of those investors turned directly to BMIS with their money. According to the complaint, Mr. Madoff and Mr. Dipascalli embarked on their now famous Ponzi scheme, and Mr. Dipascalli allegedly led the effort to book fictitious stock options transactions.[4]

The authors are only aware of a few analytic studies on the Madoff Ponzi scheme. Yet, unlike this study, no paper to date has analyzed the profitability of the JP Morgan Chase bank account. Most studies have focused on the exceptionally good risk-adjusted returns realized by feeder funds that invested in Bernie Madoff Investment Securities (BMIS). Culp and Heaton (2010) find that the excess returns of the Madoff funds should have raised questions, but the excess risk-adjusted returns by themselves could not have proven that Madoff was running a Ponzi scheme. Bernard and Boyle (2009) find that, while Madoff's feeder fund, Fairfield Sentry, had percent returns that were plausible, it

[3] The NBER put the recession as beginning in the third quarter of 1990 and ending in the first quarter of 1991.

[4] *SEC v. Frank Dipascali, Jr.*, No. 09cv7085 in the U.S. Southern District Court of New York (S.D.N.Y.) dated August 11, 2009. Accessed online on August 22, 2009, at http://www.sec.gov/litigation/complaints/2009/comp21174.pdf. The complaint filed on November 13, 2009, *SEC v. Jerome O'Hara and George Perez*, No. 09cv9425, (S.D.N.Y.), which was accessed online on December 29, 2009, site at http://www.sec.gov/litigation/complaints/2009/ohara-perez-111309.pdf, provides a similar timeline of about 15 years from 1993 to 2008. The defendants are accused of having created the computer programs that booked fake stock and stock option trade confirmations and account statements.

had low levels of volatility that were not. They show that following a similar "split-strike" strategy of options and stock investing would have generated much higher volatility over that time period. Clauss *et al.* (2009) find that the feeder funds had Sharpe ratios of investment performance that lay well above the theoretical capital market line of portfolio theory. Those funds earned Sharpe ratios, or returns in excess of the risk-free rate divided by the funds' standard deviation, which were five times greater than the S&P 500.

Other studies of the Madoff fraud focus on the regulatory failures. An example of this literature is Poser (2009). Gregoriou and Lhabitant (2009) focus on the failures of due diligence by investors in the Madoff scandal, but do not mention the JP Morgan Chase checking account.

This paper estimates the after-tax cash flows to JP Morgan Chase, given that the Madoff bank account was opened at the start of 1993 with a balance of $100 million. The starting balance was arbitrary,[5] but the ending balance of $5.5 billion is based on the August 12, 2009, complaint filed by the SEC. This account was nearly zero for most of the last quarter of 2008.[6] The authors assume that the Chase bank account led to annual before tax profits equal to the average annual balance times net interest margin (NIM). (Because this account was reportedly so large, administrative overheads were likely to be an insignificant percentage of the account balance.) Using a Monte Carlo simulation of over twelve thousand random trials, the authors estimate that the account added shareholder value of $435 million based on closing prices on October 30, 2009.

[5] The beginning balance had to be positive to generate an ending balance of $5.5 billion with geometric growth. A larger beginning balance would generate higher estimated profits for JP Morgan Chase.
[6] Claudio Gatti and Diana B. Henriques, January 29, 2009, "JP Morgan Exited Madoff-Linked Funds Last Fall," *New York Times* accessed online on August 22, 2009, at http://www.nytimes.com/2009/01/29/business/29madoff.html.

The size of this estimate is sensitive to the stock price on the end date. Higher end date stock prices will lead to higher profits from the Madoff account assuming profits are reinvested into the business. Nevertheless, even if the profits earned no interest, JP Morgan Chase's profits from the Madoff account are estimated to be $351 million. Thus, JP Morgan Chase's after-tax profits from the Madoff account are substantial, regardless of the reinvestment assumptions that are made.

In section 2, we develop a model for estimating the profits from the Chase 703 account. The results are summarized in section 2.3. In section 3 we conclude. In the appendix section 4, we discuss two complaints filed against JP Morgan Chase because of its banking relationship with Mr. Madoff's investment advisory business. We discuss the theories behind these two very different complaints and the relevant case law. Banks cannot turn a blind eye if they witness fraud, and they are required to report money laundering if they discover it.

2. Data and Analysis

2.1 Profit Estimates with a Deterministic Model of the Account Balance

To estimate the profitability of the Chase account number 140081703, the authors obtained the net interest margins reported (NIM) on the 10-K's for JP Morgan Chase going back to 1993. These were obtained from Lexis-Nexis and the SEC's Edgar cite. The NIM is defined as the difference between interest earned and interest expense, divided by average earning assets. On JP Morgan Chase's 10-K's, the less common term

"net yield on interest-earning assets" is used instead of net interest margin. The authors will use the more common term of net interest margin or NIM. The pretax annual profits were the estimated account balance in that year times the NIM for that year. Because the account fell close to zero in the last quarter of 2008, leading to Madoff's confession, this formula is slightly altered. For 2008, the pretax profits were estimated as the $5.5 billion times 0.75 times the reported NIM of 2.87 percent. From 1993 to 2008 the NIM ranged from 1.87 percent to 3.73 percent.

The NIM seems to be a good estimate of the difference in the interest rates offered to BMIS and the interest rates at which JP Morgan Chase lent out the deposits. Mr. Madoff's account likely earned money market interest rates because of its size and similar risk and liquidity characteristics to money market instruments like T-bills. In 2008, for example, 3-month T-bills averaged 1.37 percent, according to the Federal Reserve Bank of St. Louis. Negotiable Certificates of Deposit (CDs), which are not normally Federal Deposit Insurance Corporation (FDIC) insured due to their large size, earned 2.97 percent on average; and one-month, AA-rated commercial paper issued by non-financial companies earned 1.97 percent on average in 2008, according to the St. Louis Fed. These rates are comparable to the 2.26 percent that the average interest earning deposit earned at JP Morgan Chase in 2008 according to that year's 10-K. In addition, the average interest rate on interest earning assets was 5.36 percent. Thus, the difference between the rates on interest earning assets and interest earning deposits was 3.01 percent, which is greater than the NIM for the year of 2.87 percent, the latter of which was used in the analysis. It seems unlikely that Mr. Madoff or another investor could have earned much more investing in a low-risk money market mutual fund, which

would be predominately invested in T-bills because of their lower risk than both commercial paper and jumbo CDs. For most of 2008, negotiable CD's carried substantial risk because of the fears about the money center banks and the lack of a FDIC guarantee for most of the year.

To find the present value of the annual profits, we have to re-invest the cash flows until the valuation date. First, the authors multiplied the pre-tax profits based on the NIM and average balance by the marginal corporate tax rate. The marginal corporate tax rate for JP Morgan Chase, which is based in New York state was estimated to be 39.9 percent by Hodge (2008). (The marginal federal corporate tax rate was 35 percent over this period.)

The annual after-tax earnings from the Madoff account in year *t*, $EARN_t$, are calculated as the following:

$$EARN_t = BAL_t * NIM_t(1-T) \quad (1)$$

BAL_t is the average account balance in year t; NIM_t is the net interest margin in year *t*; and *T* is the marginal state and local corporate tax rate of 39.9 percent.

The authors believe it makes the most sense that the profits were reinvested in JP Morgan Chase's stock. JP Morgan Chase is the product of many mergers. In particular the stock price history of Chase Manhattan Bank is only reflected in the JPM stock price history since the merger of Chemical Bank and Chase Manhattan Bank. On March 31, 1996, Chase Manhattan Bank merged with Chemical Bank. The exchange ratio was 1.04 shares of Chemical Stock for one share of Chase Manhattan Bank stock. The stock price

history of Chemical Bank was used as the stock price history of the combined firm. Since Mr. Madoff used the Chase Manhattan Bank to store his investor's cash, the authors obtained stock prices of Chase Manhattan Bank from old editions of *The Wall Street Journal* from 1993 to March 31, 1996, to calculate stock returns prior to the merger. For stock prices after that merger the authors adjusted the closing prices on Yahoo! Finance for stock splits.

We assumed that the account balance estimated for a given year was reinvested in JPM stock on the first day of the next year until the valuation date. On October 30, 2009, the valuation date, JP Morgan Chase's stock closed at $41.77. Thus, the average account balance in 1993 was invested on the first trading day in 1994 until October 30, 2009. The authors found the annual returns with the following formula where *t* stands for year *t*. S_t stands for the closing stock price on the first trading day of the year and DIV_t stands for the sum of the dividends per share paid in year *t*.

$$R_t = \frac{S_{t+1} + DIV_t - S_t}{S_t} \tag{2}$$

Those returns were calculated for every full year up to 2009. In 2009, the ending stock price of $41.77 was used instead of the first closing price in 2010. The 2009 dividends also are only the dividends for which the *ex*-dividend date has been reached. The ex-dividend date is the day at which a buyer of the stock no longer has a right to the next quarterly dividend. The stock price, in theory, will roughly drop approximately by the amount of the dividend on the ex-dividend day. The after-tax annual profits for year *t* are denoted $EARN_t$. Thus, the total 2009 after-tax profits, PROFIT, are the following:

$$\text{PROFIT} = \sum_{t=1993}^{2008} \left(EARN_t \prod_{i=t+1}^{2009} (1+R_i) \right) \qquad (3)^7$$

The growth path could be in a straight line. In that case, the account balance would have to rise $360 million dollars per year from a beginning balance of $100 million in 1993. This is obtained from inverting $100 million + 15*K* = $5,500 million, where *K* is the annual dollar increase in the account balance. *K* = ($5,500 million – $100 million)/15 = $360 million. If the account balance followed this path deterministically, JP Morgan Chase's after-tax profits from Madoff deposits would be $803 million. Nevertheless, it seems more reasonable that the account balances would grow at a geometric, constant growth rate than by a constant dollar amount

The average account balance is assumed to follow a geometric progression from $100 million dollars in 1993 to $5.5 million in 2008. Thus, the geometric growth rate, denoted by *g*, can be calculated by inverting the following relationship, $(1 + g)^{15}$($100 million) = $5,500 million. *g* = ($5,500/$100)^(1/15) – 1 = .3122 or 31.22 percent. This is the expected path of the simulation. If the volatility of the simulation was zero, then this geometric growth path of the account balance would generate after-tax profits of $455 million.

To check how sensitive the results were to the assumption that the profits are reinvested in JP Morgan Chase's stock, the authors also calculated the profits if the

[7] For those unfamiliar with multiplication operator, an example may illustrate what it denotes. Suppose that $t \leq 2005$, then the symbol $\prod_{i=t+1}^{2009} (1+R_i) = (1 + R_{t+1})(1 + R_{t+2})...(1 + R_{2008})(1 + R_{2009})$.

reinvestment rate were zero percent per annum. If the profits were reinvested at a zero rate of interest in the non-random, geometric model, then J.P. Morgan would have $351 million in total after-tax profits today. Thus, reinvesting in the bank's stock generated profits of $104 million in excess of the annual profits. Thus, most of total 2009 estimated profits of $351 million in the geometric model are due to the past annual profits, not reinvestment returns.

2.2 A Stochastic Model of the Account Balance

It seems very unlikely that the growth of the Madoff deposits would have been smooth. To model this we have used the geometric model as a trend, but have added a mean zero normally distributed shock, ε. The authors assume that the standard deviation of this shock is 30 percent of the balance. Yet, the account balance declines geometrically backwards in time. (We only have confirmation that the account balance reached $5.5 billion in 2008, but the authors have no other data about the account balance over time.) Thus, the standard deviation is [30 percent]/(1 + .3122) of the next year's balance or 22.86 percent of the following year's balance. The shock, ε, could push the account balance below zero. Therefore, we assume that account balance cannot go below zero. Once the account balance goes to zero, in one year it will be zero in all prior years.

$$BAL_{t-1} = \max\left\{\frac{BAL_t + \varepsilon}{1+g}, 0\right\} \tag{4}$$

2.3 Results

In Figure 1, the authors plot the first eight random trials of total of the 12,012 trials conducted. The trials in Figure 1, tend to show a similar shape as the geometric trend. Despite the downward trend going backwards in time, several trials experience positive shocks that cause earlier balances to exceed later account balances.

In Figure 2, we plot a histogram of the 98.6 percent of the random trials that led to after-tax profits for JP Morgan between $100 million to less than $1 billion. The distribution of profits appears to be approximately lognormal with over half the observations generating free cash flow for JPM's shareholders between $300 million to just less than $500 million. The mean was $435 million with a standard deviation of $155 million. The mean is $20 million less than the non-random, geometric model. This difference is likely due to the fact that, when the shock has the account balance go to zero or below zero, the account balance is recorded as zero. Zero is an absorbing state. Whenever the account balance hits zero in one year, the account balance will be zero in all earlier years because the standard deviation of the shock and the trend is proportional to the next year's balance. Thus, the simulation, in theory, should generate lower average account balances than the non-random geometric model as it has in this case. In Figure 3, we plot the cumulative distribution function for the 12,012 random trials

3. Conclusion

This paper has attempted to estimate the value of the Bernie Madoff Investment Securities' (BMIS) bank account to JP Morgan Chase's shareholders. This is the first paper to attempt to estimate the profits to JP Morgan Chase generated from Mr. Madoff's deposits, which reached a balance of $5.5 billion in 2008. Because we only know a single account balance in 2008, this is a somewhat speculative task. In the authors' most preferred model, which uses the Monte Carlo simulations of the geometric growth model, we estimate that after-tax shareholder value increased by $435 million due to Mr. Madoff's very large bank account.

The fact that JP Morgan Chase may have profited greatly from the bank account, which was so closely associated with Mr. Madoff's multi-billion dollar fraud, does not necessarily mean that JP Morgan Chase engaged in any illicit or illegal activity. Few would say that the vendor who sold Mr. Madoff a hotdog on the street was doing anything wrong. Indeed, there are likely thousands of individuals and companies who did business with Mr. Madoff profitably, and in doing so engaged in no wrongdoing. Yet, if the hot dog vendor hypothetically witnessed Mr. Madoff steal a woman's purse, most would say that the vendor would have a moral obligation to call the police. Further, the vendor would have a legal obligation to not accept payment if he knew that the funds to pay for the hot dog were obtained from the lady's wallet. Finally, many would argue that the hypothetical vendor would be an accomplice to the crime if he agreed to hide the stolen purse. Thus, any claims against JP Morgan Chase would among

other things depend on what officials at Chase bank did or did not know and their duties under existing statutes and legal precedents. Such determinations of fact and law are for the courts and are beyond the scope of this paper.

A good portion of the profits that JP Morgan Chase did gain from lending out Mr. Madoff's deposits at higher rates of interest will potentially be dissipated by the pending and future legal action associated with the now infamous bank account. With the Madoff estate insufficient to satisfy creditors' demands, JP Morgan Chase is already the target of litigation arising from the Madoff account. It seems that not all profits are worth harvesting.

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4. Appendix: Legal Claims Regarding the Chase 703 Account

In the wake of Madoff's conviction, Madoff's client-victims filed numerous lawsuits against Madoff and others, including JP Morgan Chase in efforts to recover their losses. There are two pending legal complaints against JP Morgan Chase that we will discuss. The first is *MLSMK Investments Company v. JP Morgan Chase & Co. and JP Morgan Chase Bank,* NA. We refer to this complaint as *MLSMK*. The second is *Jay Wexler v. KPMG, LLP, et al*.[8] We will refer to this amended complaint filed by the plaintiff on October 20, 2009, as *Wexler*. The first alleges that JP Morgan Chase engaged in a criminal conspiracy to conceal the Madoff fraud. The second case, *Wexler,* alleges that JP Morgan Chase failed to report transactions that were markers of money laundering.

4.1 The civil conspiracy claims of *MSLMK*[9]

The plaintiff deposited $12.8 million into the Bernie Madoff Investment Securities (BMIS) account at Chase bank. *MLSMK* made the wire transfer deposits between October and December 2008, expecting Madoff and BMIS to use its money to buy and sell securities for its benefit. However, Madoff never invested *MLSMK*'s

[8] *MLSMK* has a docket number of 09-CV-4049 and is pending in the United States District Court for the Southern District of New York. *Wexler* has a docket number of 101615/09, and it is in the Supreme Court of New York County

[9] The authors' recitation of *MLSMK*'s allegations is based solely on the allegations contained in *MLSMK*'s complaint and the arguments of the parties contained in the briefs filed in support of and in opposition to the motion to dismiss the complaint filed by JP Morgan Chase. No party has introduced any evidence into the record of the district court. Thus, the plaintiff's claims have not been verified or affirmed by any court. The authors do not support or deny the truthfulness of these claims.

money. Rather, with the assistance of JP Morgan Chase, the plaintiffs allege, Madoff stole their money. According to *MLSMK*, by September 2008, JP Morgan Chase knew that Madoff used the checking account, which ended with the digits 703, in a fiduciary capacity to receive funds for investment purposes, but that, instead of investing the funds, he was stealing them. Despite their knowledge of Madoff's fraud, the plaintiffs allege that JP Morgan Chase chose to participate in the fraud by keeping the account open and transferring out the funds on deposit at Madoff's direction. In this way, JP Morgan Chase was able to maintain their lucrative association with Madoff, including his market-making business, and to continue to use the funds in the BMIS account for their own income-generating purposes. As we calculated, the reinvested after-tax profits could easily have been $435 million from 1993 to 2008.

According to *MLSMK*, JP Morgan Chase learned of the fraud through its observation of Madoff's banking activities; through its insights into Madoff's trading practices gained from its purchase of Madoff's biggest trading counter-party, Bear Stearns, in March 2008; and, through its in-house due diligence investigation of Madoff's business. In September 2008, the plaintiffs allege that JP Morgan Chase, armed with this knowledge of Madoff's fraud, withdrew its own $250 million investment from a Madoff feeder fund even though the fund was reporting a five percent positive return when the rest of the market was down substantially. JP Morgan Chase did not take similar action with other derivatives that it had written on non-Madoff funds, however.

Rather, having protected its own invested capital, JP Morgan Chase kept silent about Madoff's fraud, *MLMSK* alleges, and continued to do business with Madoff's market-making business from September 2008 until Madoff's arrest on December 11,

2008. JP Morgan Chase also provided Madoff and BMIS with banking services essential to the continued operation of the Ponzi scheme fraud and the theft of *MLSMK*'s $12.8 million, the plaintiffs claim. Specifically, JP Morgan Chase continued to permit its brokers to trade with Madoff's market making business, which provided Madoff with legitimate trading activity and volume to satisfy audits and inquiries from federal regulators and to fool the victims of his fraud. *MLSMK* concludes that JP Morgan Chase's continued provision of these services to Madoff and BMIS, despite their alleged knowledge of the fraud, was the cause of its $12.8 million loss.

MLSMK is pursing a civil claim against JP Morgan Chase under Section 1962(d) of the Racketeer Influenced and Corrupt Organizations (RICO) Act. *MLSMK* also asserts that JP Morgan Chase is liable under New York common law for aiding and abetting Madoff's breach of the fiduciary duty and commercial bad faith in failing to freeze the BMIS account. On its RICO conspiracy claim, *MLSMK* seeks treble damages, costs and attorney's fees. On its state law claims, *MLSMK* seeks compensatory and punitive damages for its $12.8 million loss.

JP Morgan Chase responded to the complaint with a motion to dismiss. JP Morgan Chase focuses on the lack of specific details of wrongdoing that the bank is alleged to have committed. In the absence of such detailed factual allegations, JP Morgan Chase contends that it is not liable to Madoff's victims simply by virtue of servicing the BMIS account.[10] *MLSMK* opposed JP Morgan Chase's motion to dismiss, and the district court scheduled oral argument on the motion for October 29, 2009. No action has been taken by the court at the time of this writing.

[10] See, *Rosner v. Bank of China*, 528 F. Supp. 2d 419, 426-27 (S.D.N.Y. 2007) and *Williams v. Bank Leumi Trust Co.*, 1997 WL 289865 (S.D.N.Y. May 30, 1997).

MLSMK is not the first case in which the victim of a fraud asserted a civil RICO claim against a bank in the wake of the public disclosure of the fraud.[11] Generally, New York courts have been reluctant to impose extra fiduciary duties on courts and have sustained motions to dismiss in civil RICO claims.[12] Yet, some of the bank cases record successful attempts by plaintiffs to plead RICO claims against bank defendants despite defendants' motions to dismiss.[13] Finally, all the cases the authors reviewed found that banks enjoyed no blanket immunity from liability under RICO claims.[14]

4.2 The Money Laundering Allegations in *Wexler*

Jay Wexler is a victim of the Madoff fraud who seeks relief in New York state court in claims brought against individual Madoff family members and business associates having connections to BMIS, Madoff feeder funds and two banking institutions—Bank of New York Mellon and JP Morgan Chase. Mr. Madoff's legitimate market-making business had an account with Bank of New York Mellon.[15]

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[11] Examples of such claims are *Rosner v. Bank of China*, 528 F. Supp. 2d 419, 426-27 (S.D.N.Y. 2007); *Williams v. Bank Leumi Trust Co.*, 1997 WL 289865 (S.D.N.Y. May 30, 1997); *Nigerian Nat'l Petroleum Corp. v. Citibank, N.A.*, 1999 WL 558141, *6 (S.D.N.Y. July 30, 1999); *Dubai Islamic Bank v. Citibank, N.A.*, 256 F. Supp. 2d 158 (S.D.N.Y. 2003).

[12] An example is *Lerner v. Fleet Bank, N.A.*, 318 F.3d 113 (2d Cir. 2003).

[13] Examples are *Charing Cross, Inc. v. Riggs Bank*, 1983 WL 2193 (D.D.C. 1983); *OSRecovery v. One Groupe International, Inc.*, 354 F. Supp. 2d 357 (S.D.N.Y. 2005); and *Kaushal v. State Bank of India*, 1988 WL 116542 (N.D. Ill. 1988). In the latter case, there are hints that the parties amicably resolved their differences after it became clear that the district court was prepared to try the cases on the merits. After denying defendants motion to dismiss as to most of plaintiffs' RICO claims, the court advised, "The parties are strongly encouraged to discuss settlement and report on the status thereof [to the court]."

[14] In one of the most damaging judgments to a large bank, the Bank of Credit and Commerce International (BCCI), pled guilty to both state and federal criminal RICO charges and, as part of its plea agreement, forfeited all of its American assets to the United States.

[15] In addition to the court filings, a good description of the two accounts is in Erin Arvedlund, September 4, 2009, "The Bank that Should Have Detected the Fraud," accessed online on December 28, 2009, at http://www.ft.com/cms/s/0/9a73da28-993e-11de-ab8c-00144feabdc0.html which is an excerpt from Arvedlund (2009).

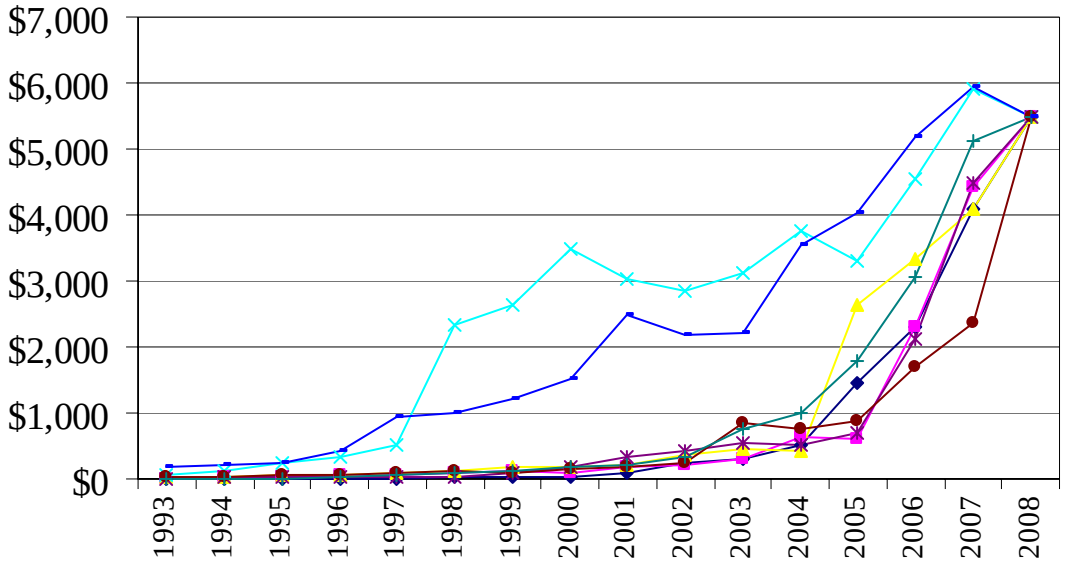
In the main, *Wexler* tracks the allegations of fact set forth in the earlier *MLSMK* case in setting forth the scope of the Madoff fraud and the culpability of the various defendants for the losses occasioned by the fraud. Unlike *MLSMK*, however, *Wexler* does not rely upon either the federal or New York state RICO statutes. Instead, *Wexler* asks for relief solely under New York state common law. With respect to Chase bank and Bank of New York Mellon, *Wexler* alleges that each of the banks was aware of and joined the Madoff fraud as a co-conspirator to aid and abet the fraud for purposes of financial gain.

In addition, Madoff's transferring of funds from New York to London and back to New York to both facilitate and conceal his fraud, as alleged in *Wexler*, amounts to international money laundering, as defined in 10 U.S.C. § 1956 (a) (2). To the extent that JP Morgan Chase and Bank of New York Mellon knowingly participated in the illegal transfers—as *Wexler* alleges—they, too, risk indictment under this federal criminal statute. The Patriot Act, signed into law by George W. Bush on October 26, 2001, required that banks (among others) file suspicious activity reports (SAR's). Under this and previous statutes, banks risk the imposition of federal administrative sanctions, either for participating in the laundering as co-conspirators or simply for ignoring money laundering and failing to file suspicious activity reports (SAR's) with the Treasury Department. Gouvin (2003), Shapiro (2005), Woodrough (2002) discuss the duties of banks under the Patriot Act and the Bank Secrecy Act of 1970. At the time of writing, however, no criminal prosecution or administrative compliance proceeding has been initiated against either Bank of New York Mellon or JP Morgan Chase to the authors' knowledge.

What is new in *Wexler* is the allegation that Chase Bank and Bank of New York Mellon failed to report suspicious transactions that were markers of money laundering. *Wexler's* contentions of money laundering attempt to avoid the traditional judicial reluctance to impose on New York banks new obligations to monitor customer accounts.[16] Yet, *Wexler* alleges that monitoring customer accounts for evidence of money laundering is now, after the enactment of the Patriot Act, a part of the business of banking. At the time of writing, neither bank has responded to the complaint. However, it is likely that both banks will move to dismiss it.

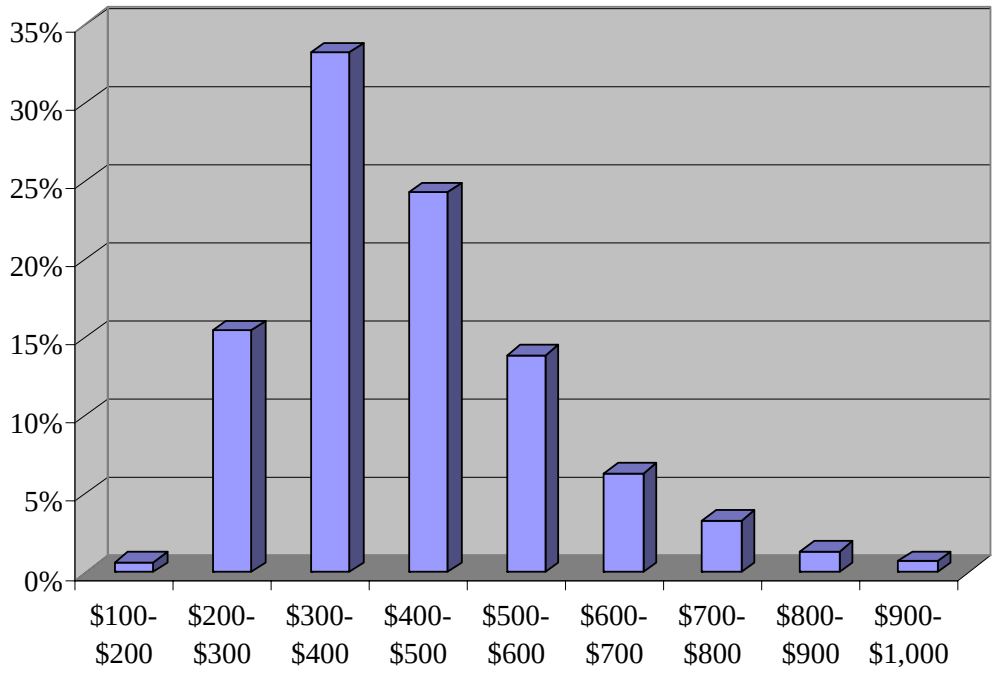
[16] An example of this reluctance is *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273 at 276 (2d Cir. 2006).

Figure 1: The First Eight Random Trials



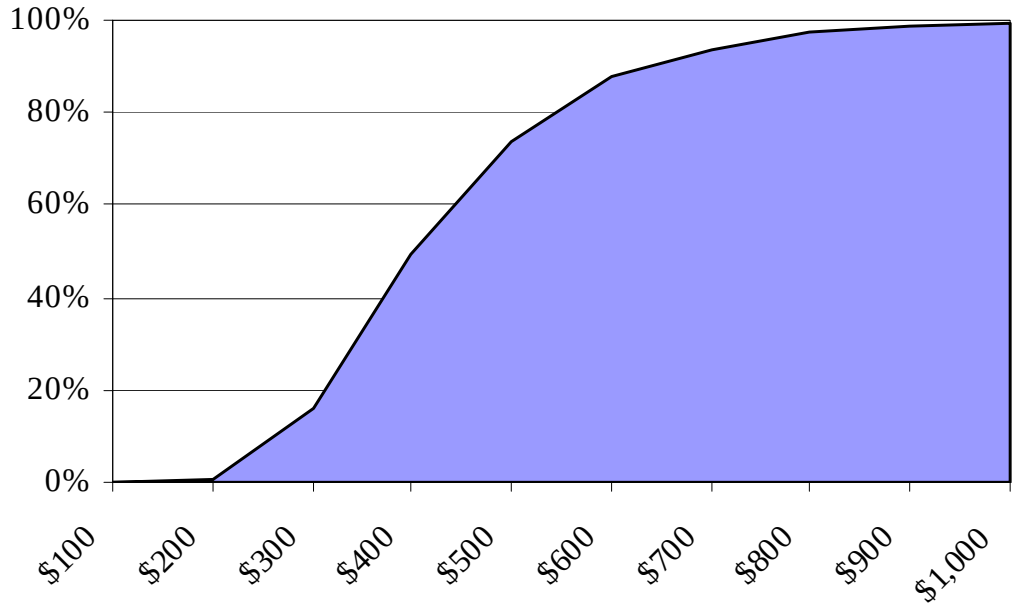
This diagram plots the average account balances by year for the first eight random trials of the simulation. In the simulation, the account balance was assumed to increase geometrically at an approximately 31.2 percent rate from its $5.5 billion balance in 2008 to its start date at the start of 1993. This trend had a mean zero, normally distributed random shock with a standard deviation equal to approximately 22.9 percent of the next year's balance or equivalently 30 percent of the present year's balance. 12,012 random trials were used for the simulation estimates. The 1993 balances are all different, but are small relative to the ending balance in 2008 of $5.5 billion, which is the same for all 12,012 random trials.

Figure 2: Histogram of the Estimated After-Tax Profits from the Madoff Deposits



All ranges are in millions of 2009 dollars. There were 12,012 random trials. 98.6 percent of the simulations lead to after-tax cash flows to JP Morgan Chase's shareholders of between $100 million to $1,000 million. Each range includes all observations less than the highest value and equal to or greater than the lower value. Annual after-tax profits were assumed to be reinvested in JP Morgan Chase's stock until the close of trading on October 30, 2009. The mean profits for holding the Madoff deposits was $435 million and the median simulation generated after-tax profits of $402 million. The minimum simulated profits were $154 million and the maximum simulated profits were $2,040 million. The standard deviation of after-tax profits was $155 million.

Figure 3: Cumulative Probability Distribution Function of the Estimated After-Tax Profits from the Madoff Deposits



This is the cumulative probability distribution function of estimated after-tax profits from the Madoff deposits. The dollar values on the horizontal axis are in millions of October 30, 2009, dollars. The distribution function is plotted in $100 million increments. The authors assumed that deposits grew at a random geometric rate with a 31.2 percent geometric growth rate and a mean zero normally distributed shock with a standard deviation of 30 percent.