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After Its Madoff Report, Can Victims Sue the SEC?

By Janet Morrissey

The SEC internal-investigation report released on Wednesday points a clear finger of blame at the agency, stating that SEC investigators missed multiple opportunities to discover Bernard Madoff's criminal activities.

But while the report hammers the SEC for repeated instances of incompetence, it stops well short of declaring the SEC liable. "The OIG [Office of Inspector General] investigation did not find evidence that any SEC personnel who worked on an SEC examination or investigation of Bernard L. Madoff Investment Securities LLC had any financial or other inappropriate connection with Bernard Madoff or the Madoff family that influenced the conduct of their examination or investigatory work," the report notes. (See a Madoff family photo album.)

In perhaps the biggest nod to SEC culpability, the OIG report says the SEC's futile investigations of Madoff were ultimately used by Madoff as a means of reassuring clients that his operations were clean, and these "had the effect of encouraging additional individuals and entities to invest with him."

Howard Elisofan, a partner at Herrick, Feinstein LLP and a former SEC enforcement attorney, launched a legal action against the SEC on behalf of a victim, Phyllis Molchatsky, last December. He has since filed eight similar complaints. "We're arguing that the SEC was negligent on multiple occasions for many reasons over multiple years, and had they detected the fraud a long time ago, thousands of people would not have been so gravely injured," he said.

Suing a government entity isn't easy, though. The process involves filing an administrative claim for relief, which, if rejected by the SEC, would allow the suit to be fought in federal district court. When a court decision is rendered, the appeal process often drags out for many years. (Read a Q&A with Bernie Madoff's mistress.)

Elisofan is encouraged by the contents of the SEC report, which he says "confirms what we've been alleging all along — that the SEC was negligent in carrying out their statutory purpose to protect the public interest."

Yet many legal experts see suits against the SEC as a steep uphill battle because government entities enjoy sovereign immunity. "To sue the government is a very tough proposition," says Dan Reinberg, a partner at Polsinelli Shughart PC. He adds that government entities have sovereign immunity for good reason. "The regulators are there to do a job that the public has asked them to do, and if they can be sued for negligence or mismanagement in their official function, then who's going to want to be a regulator?" he asks.

Overcoming the sovereign-immunity protection is the biggest hurdle, concurs David Bernfeld, a partner at Bernfeld Dematteo & Bernfeld LLC, who represents about a dozen Madoff victims. However, he believes the inspector general's report offers enough ammunition to prove negligence — which is the bullet needed to pierce the sovereign-immunity defense and make the SEC liable.

"The report was really candid. It's an astonishing litany of indifference and ineptitude" that occurred over a long period of time, Bernfeld says. "And this should be helpful in getting past the sovereign-immunity defense because it makes clear that this was not simply a decision not to investigate — it was a series of investigations undertaken but negligently performed."

However, Jim Rickards, a senior managing partner at Omnis Inc. and a former general counsel for Long Term Capital Management who helped negotiate a federal bailout for the failed hedge fund in 1998, isn't so sure the report's findings will be enough to make the SEC liable.

"The hurdle under the statute is so high — they have to show that there was an SEC rule that required them to go forward," he says. "They may have missed a lot of clues and the people were not diligent in following up on leads, but none of that shows they violated an internal rule because there's always discretion."

The SEC gets many tips, good and bad, and can't be expected to follow up on every single one, Rickards contends. "They get tips all the time — some of them are invented, some of them are malicious, some of them are people who are out to destroy other people, and they try to use the SEC as the enforcement agency," he says. "So they don't act on all of it. That's where the discretion comes in, and that's why in my view the suit will fall down."

"It's extremely unlikely" the SEC will be held liable, Rickards says.

David Schindler, a partner at Latham & Watkins who specializes in white collar and government investigations, says "human frailty" will always be a factor, and that would hold true even if tougher regulations and oversights had been in force over the past decade. "When you're a regulator and you get an allegation of wrongdoing [regarding] somebody who occupied the position in Nasdaq that Madoff did at that time, the human condition is such that it might be hard for somebody to start investigating or shooting at someone of his stature [knowing that] if they're wrong, their career and others may suffer," says Schindler. Whether a federal court will hold the SEC accountable for the "human failings of one or more personnel" is the question, he says. If it does, though, he says the ruling would open the floodgates for people to make claims in every Ponzi scheme.

David Evans, managing director at consulting firm LECG, founder of Market Platform Dynamics and editor of FinReg21.com, says there's no doubt the SEC was asleep at the wheel during the Madoff crisis. However, he believes it's next to impossible to sue a government entity and thinks it would be better if Congress stepped up to help out the victims similar to the way it assisted the automakers and others. He suggests financial assistance be limited to victims that are either nonprofit organizations or have income under a certain threshold.

"There would be a backlash to Congress bailing out billionaires who lost a few hundred million as a result of the Madoff scandal," says Evans. "But there are people who are affected by the Ponzi scheme who I think we all agree are deserving of a helping hand."

Still, some legal eagles believe Congress could set a dangerous precedent if it approved a bailout package for Madoff victims.

"Lots of people lose lots of money due to frauds every year — and so aside from the magnitude of the fraud, it's difficult to find a justification to treat Madoff's victims different than the victims of the Worldcom fraud or Enron," says Chris Clark, a partner at Dewey & LeBoeuf LLP. "I don't mean to sound unsympathetic, but it's difficult for me to imagine that Congress would legislate relief for one group of aggrieved investors when people lost billions of dollars in Lehman Brothers. Are they going to pass a statute that says you get your money back if you lost it at Lehman?"

See photos of the demise of Madoff.

Read "SEC Internal Review Cites Multiple Failures on Madoff."

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