

CLAIMS ON THE SEC FROM MADOFF THEFT

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(0.) INTRODUCTION

In Section (1.) we analyze a tort liability of the Securities and Exchange Commission (“**SEC**”) under the Federal Tort Claims Act (“**FTCA**”), as amended (28 U.S.C. § 1346(b), 2671-2680). This tort stems from the:

- (i.) failure of the SEC to comply with its own procedures in auditing Bernard L. Madoff Investment Securities LLC and Bernard L. Madoff Investment Advisors LLC,
- (ii.) the SEC falsely purporting to have conducted an audit, and
- (iii.) the subsequent loss manifest by Mr. Madoff’s 11 December 2009 announcement that the operation of his client’s managed accounts was a multi-billion-dollar Ponzi scheme.

Section (2.) considers the specific types of losses involved, and Section (3.) briefly outlines the procedure for such client’s to seek relief from the SEC. Note that the Congressional Research Office has prepared an insightful and far-more general analysis of both the Federal Tort Claims Act and the important court cases related to it.¹ That report was a guide to this analysis.

(1.) SEC LIABILITY

There is a long, well-established common-law doctrine of sovereign immunity for national governments. This was articulated in many court decision, most notably in the Supreme Court case of *Federal Housing Administration v. Burr*, 309 U.S. 242, 244 (1940). Under this doctrine, tort relief from a sovereign requires the sovereign’s consent. In the United States this was accomplished by the Senate passing a bill for each case. In 1946 the Congress sought its own relief from the volume of such bills, by granting statutory waiver of sovereign immunity for a broad class of torts. This law was revised as cited above in 1948.

With four major classes of exception, it made the United States liable:

“... for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the government while acting within the scope of his office or employment, under circumstances where the United States, if a private person would be liable to the claimant in accordance with the law of the place where the act or omission occurred.”¹

Two of these classes are basically statutory. The first appears in 28 U.S.C. § 2680(h) and is know as the Intentional Tort Exception. It excludes from the FTCA, torts: *“...arising out of assault, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contractual rights.”* unless committed by “...

¹ Cohen, Henry and Chu, Vivian S. *Federal Tort Claims Act*. Congressional Research Service 7-5700. 18 May 2009

investigative or law enforcement officer of the United States Government.” The second exception is that any liability under the FTCA stems only from a “negligent or wrongful act or omission” in 28 U.S.C. § 1346(b). This precludes “strict liability” (i.e., tort without culpability). See *Dalehite v. U.S.*, 346 U.S. 14, 44-45 (1953).

The third major class of exception arose in *Feres v. U.S.*, 340 U.S. (1950) and excludes injury to military personnel in the line of duty. In that case, the Supreme Court read the FTCA “to fit, so far as will comport with its words, into the entire statutory scheme of remedies against the Government to make a workable, consistent and equitable whole.” See that case at 139.

These major classes of exception and several minor exceptions, like the postal exception (28 U.S.C § 2680(b)) are clearly not applicable to the tort liability at hand. We are thus left with the discretionary function exception as the only one potentially at issue here. This exception is based on 28 U.S.C. § 2680(a) and precludes Government liability from torts “based upon the exercise of performance or the failure to exercise or perform a discretionary function”. The most famous interpretation of this exception is found in *Dalhite v. U.S.*, 346 U.S. 15 (1953). The Supreme Court defined that discretion by these words in that case at 34-36:

“is the discretion of the executive or administrator to act according to one’s judgment of the best course It Includes more than the initiation of programs and activities. It also includes determinations made by executives and administrators in establishing plans, specifications or schedules of operations. Where there is room for policy judgment and decision there is discretion. It necessarily follows that the acts of subordinates in carrying out the operations of governments in accordance with official directions cannot be actionable.”

The Supreme Court put a finer point on this interpretation in *Berkovitz v. U.S.*, 486 U.S. 531 (1988):

“a court must first consider whether the action is a matter of choice for the acting employee Conduct cannot be discretionary unless it involves an element of judgment or choice Thus the discretionary function exception will not apply when a federal statute, regulation, or policy specifically prescribes a course of action for an employee to follow. In this event, the employee has no rightful option but to adhere to the directive The exception protects only governmental actions and decisions based on considerations of public policy.”

In the 1999 and 2004 SEC audits of Bernard L. Madoff Investment Advisors and Bernard L. Madoff Investment Securities, the same line SEC auditor failed to follow even the most rudimentary of SEC procedures. In fact he failed to follow any established audit procedure. The most basic of any audit procedure is to confirm the assets of an enterprise, in this case the securities purchased in the Client’s managed accounts. Since no assets were ever purchased, there was no sample ever taken. No executive or administrative policy or procedure directed such failure, nor was there such to lie about it by signing the SEC finding of no violation of complainece, and thus purporting to have conducted an SEC audit. Hence, the S.E.C employee’s acts of omission and commission are not exempt from the statutory waiver of sovereign immunity afforded by the FTCA.

We find a clear match for this SEC liability in comparing two Supreme Courts decisions. In *Berkovitz v. U.S.* cited above, the Supreme Court held that the National Institute of Health’s (then) Division of Biologic Standards and the Food and Drug Administration’s Bureau of Biologics (“**NIH and FDA**”) could be held liable for failing to follow their own regulations. In this case plaintiffs claimed that these agencies:

“adopted a policy of testing all vaccine lots for compliance with safety standards and preventing the distribution to the public of any lots that fail to comply. Further allege that notwithstanding this policy, which allegedly leaves no room for implementing officials to exercise independent policy judgment, employees of the Bureau knowingly approved a lot that did not comply with safety standards.”

The Supreme Court distinguished this case from *U.S. v. Varig Airlines*, 467 U.S. 797 (1984), where it applied the discretionary function exemption to the Federal Aviation Administration’s (“FAA”) policy of only spot checking aircraft of a given type, rather than checking every plane. In that case FAA employees carried out the administrative policy, in marked contrast to the NIH and FDA employees above that failed to carryout the administrative policy of their agencies. *U.S. v. Varig Airlines* applied the standard set in *Dalehite v. U.S.*:

“Here, the FAA has determined that a program of “spot checking” manufactures’ compliance with minimum safety standards best accommodates the goal of air transportation safety and the reality of finite agency resources. Judicial intervention in such decisionmaking through private tort suits would require the courts to “second guess” the political, social, and economic judgments of an agency exercising its regulatory function It follows that the acts of FAA employees in exercising the “spot check” program in Accordance with agency directives are protected by the discretionary function exemption as well The FAA employees who conducted compliance reviews of the aircraft involved in this case were specifically empowered to make policy judgments.”

(2.) TYPES OF DAMAGES

The most obvious loss in the Madoff managed accounts is the contributed capital that was lost by clients. A more subtle loss of many investors is the opportunity cost of earnings on their contributed capital. If an investor had not invested in the Madoff managed accounts, say because the SEC had audited them, and thus discovered that there were no assets in the managed accounts, then the investor would have earned some return on that contributed capital elsewhere. The question is what return.

One answer is the return earned on the client’s other investments during the time of their Madoff accounts purported to exist. A lazy judge might prefer the simplicity of one of the Applicable Federal, either short-, mid-, or long-term. To make a Madoff victim whole as Tort law is designed to do, we would need to find what they would have earned if the SEC had actually performed the first Madoff audit in 1999 or not false signed the letter purporting to have conducted an audit. This, in turn, requires an examination of the other investment opportunities they faced. We can use the purported return up to 11 December 2009, as an upper bound on this return.

(3.) CLAIM PROCEEDURE

Within two years of first discovering the tort and its cause, the victim must present a claim to the federal agency whose employee(s) gave rise to the claim (28 U.S.C. § 2675)². If that agency mails a denial of that claim within six months, then the victim has six months to file suit in Federal District Court (28 U.S.C. § 2401, 2675). Otherwise, there is no time limit on filing suit.

² *U.S. v. Kubrick*, 444 U.S. 111, 120 (1979).