Practice

Victim Assistance

A novel legal complaint against the SEC could win Madoff victims a government bailout—and a backlash from taxpayers.

By Alison Gregor
Photographs by Garret Lown

Were they victims of a financial "serial killer" or simply poor investors? A novel legal complaint filed against the Securities and Exchange Commission (SEC) may provide answers. Some of those wiped out in the collapse of Bernard Madoff's Ponzi scheme want to hold the government responsible—and obtain compensation from American taxpayers.

With former SEC Chairman Christopher Cox admitting the agency blundered, these enraged victims may have a legal case. Phyllis Molchatsky, a New City, NY, resident, was the first Madoff victim to sue the SEC, on December 22, for $1.7 million in actual damages. She preceded a handful of others, all being represented by the 180-attorney law firm Herrick Feinstein, based in Manhattan.

If there was a poster-child for Madoff victims, Molchatsky would be it. The diminutive 62-year-old former office administrator of a brokerage firm was diagnosed at 53 with Parkinson's Disease. Her doctor recommended she retire to slow down the disease. Molchatsky, who started at the brokerage firm at 18, had cobbled together a $2-million nest egg that enabled her to take his advice.

She asked her broker, whom she declined to identify, to help her find a conservative investment fund. Among others, he gave her a performance printout for the American Masters Broad Market Prime Fund LP, a hedge fund associated with Madoff and operated by the Tremont Capital family of funds.

"What I liked about it was the fact that there were no peaks and valleys," says the soft-spoken Molchatsky. She spoke to *NYinc* accompanied by her attorney, Howard R. Elisofon, a partner at Herrick Feinstein LLC, at the firm's Park Avenue offices in April. "It wasn't very volatile. I needed something conservative, and I felt that getting nine, 10 or even 14 percent was doable. I felt very comfortable with it."

Molchatsky's broker told her that, with her money in this fund, she would be able to sleep at night—and she did. Several times, friends tried to convince her to go into what seemed to be more lucrative, but riskier, funds, and she demurred. She only dipped into her account three times, for a total of $300,000, to pay taxes on “profits” that turned out to be illusory.

Throughout this period, she kept hearing about a man named Bernard Madoff.

“I grew to admire and worship him, because I thought he was a brilliant man,” Molchatsky says. “I didn’t know him personally, but I got the feeling this fund was special—not everybody could participate.”

By 2008, Molchatsky’s account balance had peaked at $3.8 million. Confident in her financial well-being, she and her partner, a lawyer, adopted a son and began the process of adopting another child. Then came the blow. On December 11, Molchatsky saw on television, for the first time, the legendary trader she had come to admire: Bernard Madoff was being arrested for fraud in connection with a confessed $50 billion Ponzi scheme.

“My broker called and said, ‘From the way you sound, I guess you’re not watching TV,’” Molchatsky says.

“I said to my broker, ‘How much did we lose?’” she says, her voice beginning to shake. “And he said, ‘Everything.’” Hearing that, Molchatsky says she fell to the floor, banging her fists and screaming: “This is all the money I have!”

Her baby boy was crying; her partner got on the floor with her. “This was the beginning of the end for me,” Molchatsky says.

Since then, Molchatsky’s life has changed drastically. She and her partner stopped the second adoption process. They are fighting to keep their home.

Molchatsky’s options for recovering her life’s savings are bleak. She can seek compensation from the court-appointed trustee, Irving Picard, who is sorting out Madoff’s business and has recovered only $1 billion of the $50 billion Madoff extracted from thousands of investors.

Because, ultimately, that recovery may be small, Molchatsky can also participate in a class action lawsuit against Tremont Capital and its subsidiaries. She could also seek monies from the Securities Investor Protection Corporation (SIPC), a federally-established program which may repay each Madoff investor as much as $500,000. However, since Molchatsky was not a direct investor with Madoff, but one of multitudes in a feeder fund, the $500,000 awarded her fund would be divided among investors.

Lastly, Molchatsky can seek income tax relief. For the 2008 tax year, she can take a theft loss deduction equal to 75 percent of what she invested plus her earnings, minus any amount she withdrew as well as any anticipated SIPC proceeds or other recovered funds.

However, Molchatsky doesn’t work and hasn’t worked for seven years due to her Parkinson’s. To the extent that she can’t fully use her Madoff losses in 2008, the unused portion could be carried back three years and forward up to 20 years.

Compounding Molchatsky’s problems is the fact that she withdrew $300,000 from her account, which makes her subject to a clawback attempt. The trustee can require investors who received either profits or principle from their accounts to hand over that money so that it can be distributed equitably among all Madoff account holders.

New York State law allows the trustee to file clawback claims on seemingly fraudulent transfers going back as far as six years, says Therese M. Doherty, a partner with Herrick Feinstein.

“Anybody who took money out—and certainly people who took out more than their principle—could be subject to a clawback,” she says. “The obvious targets are going to be any large investor that withdrew 100 percent of their investment and closed their account within the year, because you’re going to say, ‘What did they have notice of?’”

A less likely target for a clawback would be Molchatsky, who withdrew only a small amount of money over years for a legitimate reason, Doherty says. But even if Molchatsky escapes a clawback, the overall odds of recovering anywhere near the $1.7 million she lost are slim.

Molchatsky believed her situation virtually hopeless when, in December, she approached Elisofon on a friend’s recommendation. A bespectacled figure who limits any sartorial flair to a giraffe tie, Elisofon became a trial lawyer for the SEC fresh out of law school. When clients and potential clients began approaching him in December suggesting they’d like to sue the SEC, his initial response was, “can’t be done.”

“There’s a doctrine of sovereign immunity that applies, which stems from British law and essentially means the King can do no wrong,” Elisofon says.

But as Elisofon received more requests, he began to wonder if it might be possible. When Cox made his admission that the SEC had slipped, Elisofon buried himself in the library and resurfaced with a novel legal theory.

For more than a century, the courts have been chipping away at the doctrine of sovereign immunity, he asserts, and in 1946, Congress

OPPOSITE: HOWARD ELISOFON AND PHYLLIS MOLCHATSKY. **ABOVE:** PHYLLIS MOLCHATSKY.

"[The SEC] took the voluntary testimony of [Madoff] the Ted Bundy of the financial industry, and he said, 'I didn't do anything wrong,' and they closed the case." —Howard Elisofon, Herrick, Feinstein LLC

passed the Federal Tort Claims Act, which for the first time allowed American citizens to sue an arm of the government for negligence. However, plaintiffs had to show that the government's conduct was "nondiscretionary."

"Most failures by the government are discretionary," Elisofon says. "As an example, a lot of people lost money in recent years in hedge funds. They could sue the government, saying, 'You should have regulated hedge funds.' But that's a losing case, because even if the SEC failed in the exercise of their discretion, or made a bad decision about what to regulate, the government is immune from that type of lawsuit."

So what would constitute nondiscretionary conduct? Elisofon's examples are cases where the government set up procedures that would regulate some activity, but procedures weren't followed. In one case, the Federal Aviation Administration (FAA) was successfully sued when an air traffic controller failed to follow regulations for landing planes in foggy weather. A plane crashed, killing many people.

"It's discretionary for the government to create an FAA, but it's not discretionary to operate a tower in a negligent fashion," Elisofon says.

In another case, the U.S. Coast Guard built a lighthouse on a rocky island off the coast of Louisiana and allowed the light to burn out, which led to a shipwreck.

Elisofon's position is that, not only has the SEC's former chairman admitted "multiple failures" to investigate Madoff, but the trader was audited at least three times by the SEC to no avail. "They built the lighthouse, but they let the light go out," he says. "They have audit procedures they're supposed to follow, and they failed miserably in their task of looking."

The trustee, Picard, has said there is no evidence Madoff bought any securities for his investors for at least 13 years prior to his arrest. That revelation disgusted Molchatsky, who, as a brokerage veteran, said even the most rudimentary audit should have exposed a fictitious trade history.

"I've been through audits at my own office," she says. "It's gruesome times, and they check everything. How did they miss this with him?"

For a decade, SEC investigators heard from whistleblowers, such as Boston-based former investment officer, Harry Markopolos, exposing an alleged Ponzi scheme. Elisofon has collected documents showing the SEC opened an investigation in 2006, and quickly determined that Madoff had lied to them. Still, SEC investigators failed to use subpoena powers, instead relying on information provided voluntarily by Madoff. They then closed the investigation in 2007, with a note that none of Madoff's violations was serious enough to warrant enforcement action.

"So they took the voluntary testimony of the Ted Bundy of the financial industry, and he said, 'I didn't do anything wrong,' and they closed the case," Elisofon says.

Will the SEC concede it was negligent and settle with Molchatsky and other victims? The agency declined to comment. It has six months from the December 22 date that Molchatsky filed an administrative claim to negotiate

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or respond. If the SEC ignores the claim, Molchatsky can then file her lawsuit.

Elisofon says the case is unprecedented, primarily due to the magnitude of the financial damages. "We're in uncharted waters in this type of case, but there's precedent against other agencies," he says.

Other lawyers say they believe the SEC should be sued, but doubted the case would succeed. Philip R. Michael, of counsel with Troutman Sanders LLP, who represents whistleblower Harry Markopolos, says he doesn't believe a lawsuit would stand up in court.

"You can't just start suing agencies of the United States because they neglect their duties," he says. "As a PR statement, the lawsuit may be somewhat meaningful, but I don't think a court would recognize a lawsuit."

Joel L. Friedlander, a trial lawyer in Plainview, NY, who has distant relatives ruined by the Madoff fraud, says that if the government knew an individual was being stalked and didn't prevent the stalker from hurting the victim, it would be liable.

"But generalized threats to multiple numbers of people do not necessarily call forth the responsibility to go and protect the public," Friedlander says.

Besides the legal world's pessimism, there is also evidence of a popular backlash against taxpayers bailing out Madoff victims. Joe Nocera, a *New York Times* reporter, wrote in a March 13 column: "A lot of rich, smart people who should have known better handed over their fortune to someone who turned out to be a crook…And now that it turns out that decision was as wrong-headed as a thing can be—and it has cost them a fortune— they want a government bailout? They're kidding, right?"

Neither Elisofon nor Molchatsky have a good answer as to why Madoff victims should be entitled to taxpayer compensation, but say that they believe Congress endorsed it with the Federal Tort Claims Act.

"If Congress doesn't like the idea that victims of Madoff's scheme or any other scheme could recover money, then let them repeal the statute," Elisofon says.

Molchatsky says that Madoff victims and other people have shown an outpouring of support. "They know what I'm doing is difficult, and they appreciate what I'm doing," she says. "It's a terrible thing to lose all your money, and then fear you're going to lose your home. I hope I can recoup enough to stay as long as possible—and to survive." «

BELOW: PLAIINTIFF PHYLLIS MOLCHATSKY WITH THE HERRICK, FEINSTEIN LLC TEAM (L TO R): JOHN OLESKE, LITIGATION ATTORNEY AND SECOND ATTORNEY ON SEC ACTION; CHRISTOPHER SULLIVAN, CO-CHAIR OF LITIGATION DEPT.; HAROLD LEVINE, TAX ATTORNEY; HOWARD ELISOFON, SECURITIES LITIGATOR AND LEAD ATTORNEY ON SEC ACTION; THERESE DOHERTY, SECURITIES LITIGATOR AND CLAWBACK PRACTITIONER.