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Southern District of Florida Refuses to Grant Government Motion to Dismiss Stanford Ponzi Scheme Case

Court Holds the SEC Had a Statutory Duty to Notify SIPC of Fraud

In a landmark decision on September 7, 2012, the United States District Court for the Southern District of Florida held that victims of the Stanford Ponzi scheme could survive the Government's motion to dismiss because they had adequately pled that the Securities and Exchange Commission ("SEC") violated a specific, statutory duty. This groundbreaking decision represents a rare, successful attempt to challenge the SEC's sovereign immunity and plead a cause of action for liability on the part of the SEC with regard to its response to a fraudulent scheme. In issuing the decision, the court ruled that the SEC is not protected by sovereign immunity where, as here, the Plaintiffs can point to a specific, non-discretionary statutory obligation that the SEC allegedly failed to meet.

Synopsis

Zelaya v. United States involves two investors, Carlos Zelaya and George Glantz, who filed a class action complaint against the United States, asserting a claim for negligence under the Federal Tort Claims Act ("FTCA").[1] By their complaint, Plaintiffs alleged that R. Allen Stanford created the "Stanford Group Company" ("SGC") to promote investments as part of a massive Ponzi scheme.[2] The SEC allegedly acted negligently in its handling of the SGC scheme by failing to take action against SGC until 2009, even though the SEC had received numerous complaints about SGC and conducted several investigations between 1997 and 2004. Plaintiffs claimed that as early as 1997, the SEC had concluded that Stanford was operating a Ponzi scheme.[3] In ruling on the Motion to Dismiss, the court held that Plaintiffs could proceed on their claim that the SEC violated its statutory obligation to report SGC to the Securities Investor Protection Corporation ("SIPC").[4]

Prior Claims Against the SEC: Barred by Sovereign Immunity

The Madoff scheme and other investment scams have caused widespread financial loss to investors. Because such investors invariably are unable to recover all of their losses from the perpetrators, they typically assert claims against solvent third parties, including banks, brokerage firms, hedge funds and auditors who may have had some connection to the scamsters. Recently, investors also have sought recourse against the SEC, challenging the SEC's failure to detect, investigate or thwart these schemes. Not surprisingly, most of these attempts to hold the SEC accountable have failed, because the SEC enjoys sovereign immunity and broad

1 *Zelaya et al v. United States*, *11-cv-62644, Order Granting in Part and Denying in Part Defendant's Motion to Dismiss ("MTD").*
2 *Id.*

3 Although Plaintiffs did not refer in their complaint to specific documents that establish that the SEC concluded prior to 2009 that SGC was a Ponzi Scheme, by surviving the motion to dismiss, plaintiffs will attempt to prove that allegation through discovery.
4 *See* 15 U.S.C. § 78eee(a)(1) which provides: "[i]f the Commission...is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or approaching financial difficulty, it *shall* immediately notify the [Securities Investor Protection Corporation]." (emphasis added).

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discretion under the Securities Exchange Act of 1934 in deciding whether and how to investigate suspected wrongdoing.

Generally, sovereign immunity protects the United States from liability absent its consent, and bars suits based on lack of subject-matter jurisdiction.[5] The FTCA is a limited waiver of this sovereign immunity and allows the Government to be held liable for damages "caused by the negligent or wrongful act or omission of any employee of the Government."[6] This waiver of immunity is limited by the "discretionary function exception," which states that the United States will not be held liable for "the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government."[7] In order to determine whether challenged conduct falls within the discretionary function exception, courts apply a two-part test. First the court must ask whether the challenged act involves an "element of judgment or choice."[8] If the conduct satisfies that test, the court will then consider "whether that judgment is of the kind that the discretionary function exception was designed to shield."[9]

The rationale behind the SEC's sovereign immunity and the discretionary function exception is "to prevent judicial second-guessing of legislative and administrative decisions grounded in social, economic, and political policy through the medium of an action in tort."[10] Courts have found themselves ill-suited to oversee the decisions of the SEC due to the inherently policy-oriented nature of its decisions. As a result, Congress created the discretionary function exception, which effectively insulates the SEC from such civil litigation.[11]

The most recent and widely reported claim of this kind alleged gross negligence by the SEC in its oversight, investigations, and examinations of Bernie Madoff and his firm, Bernard L. Madoff Investment Securities LLC.[12] In the wake of the discovery of the Madoff Ponzi scheme, aggrieved investors made claims alleging that the "SEC failed despite numerous tips, warnings and putative investigations, to discover, disclose and put an end to the scheme from 1992 until 2008."[13] In that case, the District Court for the Southern District of New York granted the Government's motion to dismiss because Plaintiffs had failed to identify any specific, non-discretionary mandates, regulations or rules that allegedly were violated by the SEC.[14] The court held that the SEC was protected by sovereign immunity despite the fact that the SEC's Office of the Inspector General had found that the SEC "never took necessary and basic steps to determine if Madoff was misrepresenting his trading," even after receiving eight complaints that alleged Madoff was operating a Ponzi scheme.[15] The court reasoned that the Plaintiffs had not described any mandatory case-opening, case-management or other administrative or investigative protocol that allegedly had been performed negligently. The court held that the "boundaries of the

5 *FDIC v. Meyer*, 510 U.S. 471, 475 (1994).
6 28 U.S.C. § 1346(b)(1).
7 28 U.S.C. § 2680(a).
8 *United States v. Gaubert*, 499 U.S. 315, 323 (1991).
9 *Id.*
10 *Id.*

11 *Bd. Of Trade of Chicago v. SEC*, 883 F.2d 525, 531 (7th Cir. 1989).
12 *Molchatsky v. United States of America*, 778 F. Supp.2d 421, 425 (S.D.N.Y. 2011).
13 *Id.*
14 *Id.* Although Plaintiffs' Complaint in *Molchatsky* attempted to prove a mandatory duty existed to disclose investigatory information to other authorities and alleged that there had been "a serious failure to follow appropriate protocols" in connection with Madoff, the Court was unconvinced that a non-discretionary duty had been identified.
15 *Id.* at 425-26.

[discretionary function exception] are not . . . delineated by best practices or even the absence of logical, responsible practices. Claims escape its scope only where the injury-producing government action was specifically non-discretionary, or where a discretionary action that caused the injury was not one that was susceptible to policy analysis."[16]

Zelaya Plaintiffs Successfully Plead a Nondiscretionary Duty

Unlike Madoff and other previous cases, Plaintiffs in *Zelaya* successfully pled the SEC's alleged violation of a specific non-discretionary duty. Plaintiffs made two claims. First, they alleged that the SEC was negligent in failing to notify SIPC that SGC was in financial difficulty upon determining it was a Ponzi scheme. Second, they asserted that the SEC was negligent when it failed to deny continued registration to SGC after determining that SGC did not satisfy registration requirements.[17]

For their first argument, Plaintiffs relied on 15 U.S.C. § 78eee(a)(1), which provides: "[i]f the Commission...is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or approaching financial difficulty, it *shall* immediately notify the [Securities Investor Protection Corporation]" (emphasis added). According to Plaintiffs, as soon as the SEC learned that SGC was operating as a Ponzi scheme, it was effectively notified that the company was "in or approaching financial difficulties," because a Ponzi scheme, by its nature, is an entity which is insolvent at its inception.[18] Plaintiffs argued that by failing to notify SIPC, the SEC breached its duty under the statute.

In response, the Government argued that a determination that SGC was operating as a Ponzi scheme was not equivalent to making a determination that the company was in or approaching financial difficulty.[19]

The court rejected the Government's argument, citing Black's Law Dictionary which states:

> A Ponzi scheme is a 'fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors. Money from the new investors is used directly to repay or pay interest to earlier investors, usually without any operation of revenue producing activity other than the continual raising of new funds.'[20]

The court went on to state that "if the SEC concluded SGC was operating as a Ponzi scheme, then, by definition, it concluded that [SGC] was in or approaching financial difficulty which triggered a nondiscretionary duty to report."[21]

The court, however, dismissed Plaintiffs' claim with regard to the SEC's duty to refuse SGC's re-registration. It found that neither the statute nor the regulation requires the SEC to take any action in reviewing or approving investment advisors' registration amendments. Accordingly, the SEC's treatment of an investment advisor's

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16 *Id*. at 434.
17 In making their second claim, Plaintiffs relied on 15 U.S.C. § 80b-3(c), which allows investment advisors to become "registered" by filing an application with the SEC and provides that the SEC "shall" either grant the registration or alternatively, "institute proceedings to determine whether registration should be denied."
18 *Zelaya et al v. United States*, 11-cv-62644, Order Granting in Part and Denying in Part Defendant's MTD.
19 *Id*. at p. 4 of 8.
20 *Id*. (citing *Black's Law Dictionary 1278 (9th ed. 2009)*).
21 *Id*. at p. 5 of 8.

amendment to its Section 80(b)-3 registration application involves an element of judgment grounded in policy considerations and falls under the discretionary function exception of the FTCA.[22]

The court gave Plaintiffs the opportunity to file an amended complaint consistent with the court's ruling.

Conclusion

Because the SEC enjoys sovereign immunity and complete discretion under the Securities Exchange Act of 1934 in deciding whether and how to investigate suspected wrongdoing, most FTCA suits challenging SEC decisions to investigate, remediate or prosecute alleged wrongdoing have been unsuccessful. In *Zelaya,* on the other hand, Plaintiffs succeeded in articulating a specific, identifiable and mandatory duty that the SEC violated and were able to adequately state a cause of action for the breach of this duty under 15 U.S.C. § 78eee(a)(1). It will be interesting to follow subsequent developments in *Zelaya* and to see whether it serves as a springboard for other cases in which Plaintiffs attempt to plead that the SEC violated a specific non-discretionary obligation, and therefore that the protections of sovereign immunity do not attach. ■

22 *Id.* at p. 7 of 8.

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