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Victims of Madoff Seek Claims Overhaul

By DIANA B. HENRIQUES

In a step that would substantially increase the price tag for Bernard L. Madoff's long-running Ponzi scheme, lawyers for a group of his victims are asking a federal bankruptcy judge to reject the way their losses in the fraud are being calculated.

The customers say that, by law, they should be given credit for the full value of the securities shown on the last account statements they received before Mr. Madoff's arrest in mid-December, even though they were bogus and none of the trades were ever made. According to court filings, those account balances add up to more than $64 billion.

After months of private negotiations and Internet arguments, lawyers for these customers formally put the issue before the federal bankruptcy court in New York in a lawsuit filed late Friday evening, less than a month before the deadline for filing claims for compensation.

The approach they seek would produce a significantly higher tally of cash losses than the formula being used by the court-appointed trustee overseeing the claims process for the Securities Investor Protection Corporation, a government-chartered agency financed by the brokerage industry.

The trustee, Irving H. Picard, is calculating investor losses as the difference between the total amount a customer paid into the scheme and the total amount withdrawn before it collapsed.

Customers who qualify are eligible for up to $500,000 in immediate compensation from SIPC. Those whose eligible losses exceed that amount would divide up the assets recovered by the trustee.

Thousands of long-term investors, including elderly people who lived for decades on withdrawals from their Madoff accounts, do not qualify for SIPC payments because they withdrew considerably more over time than they originally entrusted to Mr. Madoff, Barry Lax, a lawyer for the plaintiffs, said.

Some of them desperately need the money they would receive from SIPC if the final account balances were taken into consideration, Mr. Lax said.

"We are talking about some of the saddest cases imaginable," he said. "These are people in their 70s and 80s who cannot work and have no possible source of income to replace the money" lost in the fraud.

He added: "Under the trustee's approach, thousands of people will not get a dime. That doesn't seem fair to me — it leaves out the people most affected by the fraud."

David J. Sheehan of Baker Hostetler, a lawyer for Mr. Picard, declined to comment on the litigation.

The outcome of the dispute will be important for SIPC and the brokerage firms that pay into its compensation fund. So far, with more than 8,800 claims filed, most investors with valid claims have qualified for the full $500,000 payment. If all the claims follow that pattern, the expense to SIPC for Madoff claims could approach $4.4 billion — a sum the taxpayers would have to cover if SIPC could not.

The claims calculation issue has been simmering for months, as customers' lawyers met with officials at the Securities and Exchange Commission, which has jurisdiction over SIPC, and with lawyers for Mr. Picard. But its resolution has become more urgent with the approach of the July 2 deadline for filing SIPC claims.

Even if the courts overrule Mr. Picard's approach, victims who did not file a claim before that deadline will not be eligible for compensation, Mr. Lax said.

"Many thousands of victims have not bothered to file a claim, assuming it would be rejected," he said. Therefore, the class-action case filed by his firm, Lax & Neville, also asks the court to rule that any victims affected by the lawsuit would automatically be deemed to have filed a claim before the deadline.

The essence of a Ponzi scheme is that the money one investor takes out, if it exceeds the cash that investor puts in, actually comes from another investor's pocket, not from any legitimate source. As long as more cash was coming in than was being withdrawn, Mr. Madoff used money from new investors to cover withdrawals by other investors.

When the cash to cover withdrawal demands ran out, he confessed to his sons that his money management operation was a fraud and was arrested. After pleading guilty to federal fraud and money-laundering charges in March, he was jailed to await sentencing, scheduled for this month.

To complicate the question of calculating losses, the trustee has asserted in litigation that Mr. Madoff gave some investors credit for higher rates of return than other investors received — meaning they could withdraw more money from the scheme than others.

The account balances that Mr. Lax's clients want to use as the basis for their losses also reflect Mr. Madoff's sleight of hand, because the value of the stocks or Treasury securities shown on them increased according to his whim. A customer who was favored with a higher rate of return wound up with a larger fictional balance than a customer who put in and took out the same amount of cash but was not favored.

In a recent interview, Mr. Picard argued that recognizing these fraudulent transactions as the basis for actual cash losses would be to "allow the thief to pick the winners and losers."