SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: BERNARD J. FRIED PART 60

HON. BERNARD J. FRIED Justice

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Cannonball Fund, Ltd., et. al.,

Plaintiffs,

-against-

Marcum & Kliegman, LLP,

Defendant,

and

Dutchess Private Equities Fund, L.P.,

Nominal Defendants.

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Index No. #651674/2011

MOTION DATE _____

MOTION SEQ. NO. #001

MOTION CAL. NO. _____

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

The following papers, numbered 1 to _____ were read on this motion to/for _____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

This motion is decided in accordance with the attached memorandum decision.

SO ORDERED.

Dated: 4/5/2012

HON. BERNARD J. FRIED J.S.C.

Check one: ☒ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST [ ] REFERENCE

☐ SUBMIT ORDER/JUDG. ☐ SETTLE ORDER/JUDG.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : PART 60

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CANNONBALL FUND, LTD., CANNONBALL PLUS FUND, LTD., EAST ORIENT LTD., MARK WENZEL, THE TRUSTEES OF THE GERALDINE K. SCHWAB REVOCABLE TRUST, and THE CARRSWOLD PARTNERSHIP, Individually on Behalf of Themselves and Derivatively on Behalf of DUTCHESS PRIVATE EQUITIES FUND, L.P. and DUTCHESS PRIVATE EQUITIES CAYMAN FUND, LTD.,

Plaintiffs,

Index No.:
651674/2011

-against-

MARCUM & KLIEGMAN, LLP,

Defendant,

and

DUTCHESS PRIVATE EQUITIES FUND, L.P., DUTCHESS PRIVATE EQUITIES CAYMAN FUND, LTD., and DUTCHESS PRIVATE EQUITIES FUND, LTD.,

Nominal Defendants.

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APPEARANCES:

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FRIED, J.:

Plaintiffs bring this action against Marcum & Kliegman, LLP ("M&K"), alleging professional malpractice stemming from M&K's engagement as an auditor of Dutchess Private Equities Fund, L.P. and Dutchess Private Equities Cayman Fund, Ltd. (the "Funds") in 2008. Defendant M&K moves to dismiss the complaint pursuant to CPLR 3211(a)(1) and (7).

On a motion to dismiss pursuant to CPLR 3211(a)(7), the complaint is to be liberally construed and the facts alleged therein are accepted as true. 511 West 232nd Owners Corp. v. Jennifer Realty Co., 98 N.Y.2d 144, 152 (2002). Although the plaintiff is entitled to the benefit of all possible inferences, no such benefit exists when "allegations consist[ ] of bare legal conclusions as well as factual claims flatly contradicted by documentary evidence." Maas v. Cornell Univ., 94 N.Y.2d 87, 91 (1999). A motion to dismiss pursuant to CPLR 3211(a)(1) "may be appropriately granted only where the documentary evidence utterly refutes plaintiff's factual allegations, conclusively establishing a defense as a matter of law." Goshen v. Mutual Life Ins. Co. of N.Y., 98 N.Y.2d 314, 326 (2002).

Briefly, the allegations giving rise to this action are as follows. According to the Complaint, the Funds were hedge funds with a similar stated strategy of investing in companies with positive cash flow and in fully secured or liquid securities. (Complaint ¶¶ 27, 36). The Funds' common investment manager was Dutchess Capital Management LLC. (Complaint ¶ 16). Between 2004 and 2007, Plaintiffs invested over $13 million in the Funds, with the bulk of the investments made in 2006 and 2007. (Complaint ¶¶ 6-11).

Plaintiffs allege that the Funds' management and directors engaged in a scheme to advance their own interests to the detriment of the Funds and their investors. (Complaint ¶ 69). Plaintiffs allege that the scheme encompassed nondisclosure of conflicts of interest, fraud in investment valuation, and negligent misrepresentation of investment strategies. (Complaint ¶¶ 69, 72). Plaintiffs point to two specific investments as evidence of the management's wrongdoing. (Complaint ¶ 4). Plaintiffs allege that from 2003 through early 2008, the Funds invested $30 million in two companies: Challenger Powerboats, Inc. ("Challenger") and Siena Technologies, Inc. ("Siena"). (Complaint ¶ 4). Plaintiffs allege that in spite of the Funds' stated investment strategy of investing only in companies with "substantial secure asset coverage and positive cash flow," both Challenger and Sienna continually operated at a loss and that these two companies had very few assets securing the Funds' investments. (Complaint ¶¶ 4, 105, 139, 148, 154-55). The value of the Funds' investments in both Challenger and Siena has since been significantly reduced, resulting in substantial losses to the Plaintiffs. (Complaint ¶¶ 5, 120).

On November 10, 2006, M&K was engaged to audit the financial condition and the statements of assets and liabilities of the Funds for the year ending on December 31, 2007. (Complaint, Exhibits B, C). On June 16, 2008, M&K issued an unqualified and clean audit opinion of the Funds' financial condition for the year ending on December 31, 2007 ("Audit Opinion"). (Complaint ¶¶ 23, 191). Plaintiffs allege that M&K violated its professional duty of care by issuing a false and misleading Audit Opinion. (Complaint ¶ 190). Plaintiffs allege that the Audit Opinion was negligently prepared because M&K did not perform the audits in accordance with Generally Accepted Auditing Standards ("GAAS"). (Complaint ¶ 192).

Plaintiffs allege that the Funds' financial statements overvalued the Challenger and Siena investments and failed to disclose the Funds' management's failure to comply with the Funds' stated investment strategies. (Complaint ¶ 199). Plaintiffs allege that M&K was negligent and violated its obligations under GAAS by failing to detect these misrepresentations in the Funds' financial statements and by failing to take any action to remedy these discrepancies once M&K had discovered them. (Complaint ¶¶ 216-17, 221). Plaintiffs allege that once these discrepancies were discovered, M&K had a duty to ensure that either the Funds' financial statements (that were also issued in June 2008) or the Audit Opinion were modified. (Complaint ¶ 221).

Plaintiffs allege that they suffered damages as a result of M&K's negligence. (Complaint ¶ 238). Plaintiffs allege that had M&K performed a proper audit, or, alternatively, refused to certify the Funds' financial statements, then Plaintiffs would have been alerted to the Funds' problems. (Complaint ¶ 238). Plaintiffs allege that, armed with this knowledge, they could have made an informed decision as to whether they should remain invested in the Funds or put in requests for "gated redemptions, in which investors could request redemption, subject [to] an amount and timing to be determined by" the Funds. (Complaint ¶ 60). Alternatively, Plaintiffs allege that they could have removed the Funds' management or changed the Funds' investment strategy. (Complaint ¶ 238).

M&K moves to dismiss the complaint pursuant to CPLR 3211(a)(1) and (7). M&K argues that the allegedly negligent Audit Opinion could not have proximately caused the Plaintiffs' injuries. The Audit Opinion was issued on June 16, 2008. (Complaint ¶ 60). However, all of the redemptions from the Funds were suspended in February 2008 and since

that time the Plaintiffs were effectively prohibited from withdrawing their investments. (Complaint ¶ 174). Plaintiffs have demanded full redemption from the Funds, and their demands have been denied. (Complaint ¶ 183). Thus, M&K argues that even if the Audit Opinion had disclosed different information, the resulting losses to the Plaintiffs would have been the same.

In opposition, Plaintiffs first argue that the issue of proximate cause is not appropriate to consider at the motion to dismiss stage. However, it is well established that proximate cause is an essential element of a *prima facie* case of accounting malpractice. Herbert H. Post & Co. v. Sidney Bitterman, Inc., 219 A.D.2d 214, 223 (1st Dep't 1996) ("Proof of proximate causation is an essential element of any malpractice claim, including accountant's malpractice.") Thus it is appropriate for me to consider the issue of proximate cause on a motion to dismiss. See O'Callaghan v. Brunelle, 84 A.D.3d 581, 582 (1st Dep't 2011) (granting defendant's motion to dismiss a legal malpractice action for failure to establish both proximate cause and negligence); Turk v. Angel, 293 A.D.2d 284, 284 (1st Dep't 2002) (granting defendants' motion to dismiss a legal malpractice action due to plaintiffs' inability "to demonstrate that, but for defendant's conduct," plaintiffs would have been a successful bidder at a Bankruptcy Court hearing).

Next, Plaintiffs argue that it does not matter that all of the redemptions had stopped at the time the Audit Opinion was issued because this action is brought derivatively on behalf of the Funds. Plaintiffs argue that had the Audit Opinion properly disclosed the problems in the Funds' financial statements, the Funds themselves could have taken different actions after the Audit Opinion was released. Plaintiffs argue that they could have replaced the

Funds' existing management with new managers who "could have tried to maximize investor returns and avoid further declines in value." (Plaintiffs' Memorandum of Law in Opposition p. 16).

However, any new management hired after the Audit Opinion was issued could not have done anything to rectify the losses incurred by the Funds' prior to the time the Audit Opinion was issued in June 2008. For example, in April 2008, two months prior to the issuance of the M&K Audit Opinion, the Funds reported a 33% loss, partially due to the decline in value of the Funds' investment in Challenger. (Complaint ¶ 177). Any new management hired after June 2008 could not have prevented this loss.

Furthermore, Plaintiffs' argument that any new management could have avoided losses suffered after June 2008 is speculative. Plaintiffs fail to specifically allege how the Funds' new management could have salvaged the Funds' investments, or whether it was even possible to replace the Funds' management. This failure to allege specific courses of actions makes any damages asserted by the Plaintiff speculative. See Pearlman v. Friedman Alpren & Green LLP, 300 A.D.2d 203, 203 (1st Dep't 2002) (upholding the dismissal of plaintiff's accounting malpractice claim because the allegations in support of the causation element were "grossly speculative"); Leff v. Fulbright & Jaworski, L.L.P., 78 A.D.3d 531, 533 (1st Dep't 2010) (upholding a dismissal of plaintiff's legal malpractice action because plaintiff did not specifically allege what her late husband would have done had he received different advice from defendants); Perkins v. Norwick, 257 A.D.2d 48, 51 (1st Dep't 1999) (granting a motion to dismiss a legal malpractice action based on failure to allege proximate cause, because Plaintiff's proposed courses of action were "gross speculation on future events.")

Plaintiffs cite to Sacher v. Beacon Assocs. Mgmt. Corp., No. 09-005424, 2010 WL 1881951 (Sup. Ct. Nassau County Apr. 26, 2010) and Hecht v. Andover Assocs. Mgmt. Corp., No. 09-006100, 2010 WL 1254546 (Sup. Ct. Nassau County Mar. 12, 2010) in support of their position that the Complaint adequately pleads proximate cause. However, these cases are distinguishable. In Sacher, plaintiffs alleged that as a result of the auditor's negligence, hedge fund Beacon Associates invested most of its assets with Madoff funds. Sacher, 2010 WL 1881951, at *4. Here, there are no similar allegations that the Funds' flawed investments were made as a result of M&K's negligence. Indeed, all of the losses suffered by the Funds were the result of investments that were made prior to M&K's involvement. In Hecht, having no information to the contrary, the court had to assume that a "proper audit would have provided [a hedge fund] with the opportunity to liquidate its investment" prior to Madoff's bankruptcy. Hecht, 2010 WL 1254546, at *14. Here, no such assumption can be made, because the Plaintiffs admit in their Complaint that all of the redemptions were frozen several months prior to the issuance of the Audit Opinion, and that their requests to redeem their investments have been unsuccessful. (Complaint ¶ 174, 183). Therefore, I conclude that the Plaintiffs would not have been able to redeem their investments when M&K issued its Audit Opinion.

Finally, Plaintiffs argue that M&K was negligent in its failure to report the misrepresentations and overvaluations in the Funds' financial statements on a timely basis and in the "inexcusable delay" in issuing the Audit Opinion. Plaintiffs argue that had M&K reported the financial fraud earlier (possibly even in 2007), then Plaintiffs would have been alerted to the inflated valuations and management misconduct. With this knowledge,

Plaintiffs would not have made additional investments in the Funds and could have redeemed their shares prior to February 2008, when the redemptions were frozen.

However, this new theory of negligence was not set forth in the Plaintiff's Complaint, and was raised for the first time in the Plaintiffs' Memorandum of Law in Opposition to the Motion to Dismiss. Allegations raised for the first time in the Memorandum of Law will not be considered by the court on a motion to dismiss. See Edison III Fund Ltd. v. Irvine Capital Partners, L.P., No. 06-0603043, 2007 WL 2815477, at *3 (Sup. Ct. New York County July 23, 2007) ("to determine [a] motion [to dismiss], the court will consider only the allegations in the complaint"); see also Phelan v. State, 238 A.D.2d 882, 883 (4th Dep't 1997) (allegations contained for the first time in the memorandum of law in opposition to a motion to dismiss will not be considered by the Appellate Division); Forest Creek Equity Corp. v. Dep't of Envtl. Conservation, 168 Misc. 2d 567, 572 (N.Y. Sup. Ct. 1996) ("the court is not able to consider factual allegations raised in a memorandum of law that are not part of the record before the court.") Therefore, I will not consider this new theory of negligence.

Accordingly, Plaintiffs have failed to allege that M&K's negligence was the proximate cause of Plaintiff's damages and thus the Complaint fails to state a cause of action for accounting malpractice.

Accordingly, it is

ORDERED that Defendant's Motion to Dismiss is GRANTED and the Complaint is dismissed; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

DATED: 4/5/2012

ENTER:

J.S.C.
HON. BERNARD J. FRIED