UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE J. EZRA MERKIN AND BDO SEIDMAN SECURITIES LITIGATION	08 Civ. 10922 (DAB)

PLAINTIFFS' OPPOSITION TO THE MOTION OF DEFENDANTS BDO SEIDMAN LLP TO DISMISS

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Lead Plaintiffs New York Law School ("NYLS"), Scott Berrie ("Berrie") and Jacob E. Finkelstein CGM IRA Rollover Custodian ("Finkelstein") (together "Plaintiffs"), individually and on behalf of all other persons similarly situated, respectfully submit this memorandum of law in opposition to the motion of Defendant BDO USA, LLP ("BDO"), to dismiss the Third Consolidated Amended Class Action Complaint ("TAC"). To avoid burdening the Court, Plaintiffs incorporate by reference herein their concurrently filed opposition to the motion to dismiss filed by Defendants J. Ezra Merkin ("Merkin") and Gabriel Capital Corporation ("GCC") ("Merkin Opp'n"), and address here only facts and arguments specific to BDO and its affiliated off shore co-defendants BDO Tortuga ("Tortuga") and BDO Binder ("Binder"). Plaintiffs also incorporate by reference herein their separate opposition to the motion to dismiss filed by Tortuga and Binder ("BDO II Opp'n").

PRELIMINARY STATEMENT

In *CRT Investments, Ltd. v. Merkin*, Index. No. 601052/90, slip op. (N.Y. Sup. Ct. N.Y. Co. Nov. 11, 2009), Justice Richard B. Lowe, noting that the complaint before him alleged only that BDO had access to, but not actual knowledge of, red flags of Madoff's fraud, "reluctantly" dismissed plaintiffs' common law fraud claim, writing:

> The Court notes that these types of allegations of scienter against auditors of investments funds in these situations appear to be recurring, yet they cannot go beyond the motion to dismiss stage and into discovery under the present state of the law. The inability to explore the alleged wrongdoing any further and potentially hold these parties accountable is frustrating to the court.

This frustration, most deeply felt by Merkin's clients, who collectively lost approximately $2.4 billion to Madoff as a result of Merkin's greed and BDO's wrongdoing, should now come to an end. Merkin's deposition testimony in *New York University v. Ariel Fund Limited*, Index No. 603803/2008 (N.Y. Sup. Ct. N.Y. Co.) ("NYU Action") unequivocally establishes that BDO was

aware of "concrete facts indicating the fraud" that the Court found were lacking in *CRT*. Merkin testified that he had ***discussions with BDO about warnings he had received about Madoff's suspect trading strategy and impossibly high and stable returns, including a specific warning that Madoff was likely running a Ponzi scheme.*** Despite knowing these concrete facts, which would have prompted any reasonable auditor to take the additional steps required by GAAP and GAAS, BDO, one of the largest accounting firms in the world, did ***nothing*** even to verify that the Funds' billions in assets custodied with Madoff actually existed. These facts, together with the many other red flags of both Madoff's and Merkin's potential fraud, are sufficient to establish BDO's scienter even under the most exacting standards. Consequently, Plaintiffs' securities fraud and common law fraud claims must stand.

Plaintiffs' other claims are equally strong. Because BDO unquestionably knew Plaintiffs would rely on their clean audit reports, their negligent misrepresentation claim should be upheld. In *Anwar v. Fairfield Greenwich, Ltd.*, ("*Anwar II*"), No. 09 Civ. 0118 (VM), 2010 U.S. Dist. LEXIS 86716, at *78 (S.D.N.Y. Aug. 18, 2010), Judge Marrero refused to dismiss a negligent misrepresentation claim against an auditor that issued clean audit reports for other Madoff feeder funds even though, unlike here, there were no allegations there that the auditors had actual knowledge of the red flags. That Merkin ***told*** BDO about the "risks" associated with Madoff's strategy and returns, and nonetheless issued clean audit reports on the Funds, is also sufficient to state valid claims for breach of fiduciary duty against BDO as well as for aiding and abetting Merkin's breaches of fiduciary duties to the Funds' investors. Plaintiffs also state a valid unjust enrichment claim against BDO, because equity requires that BDO's fees, which were paid by Plaintiffs and the Class, should be returned. Finally, BDO's argument that Plaintiffs lack standing to pursue their claims, despite having suffered individual losses by investing in Funds

that were the vehicles for accomplishing the fraud, should not be countenanced. BDO's motion to dismiss Plaintiffs' claims should be denied in all respects.

STATEMENT OF FACTS

BDO was the "independent" auditor for Ascot Partners, L.P. (the "Ascot Fund") and Gabriel Capital, L.P. (the "Gabriel Fund" or "Gabriel"), and, together with Tortuga or Binder, also audited the Ariel Fund Limited (the "Ariel Fund" or "Ariel"),[1] Gabriel's off-shore twin. ¶¶ 26-28. BDO, Tortuga and Binder (the "BDO Defendants" or "BDO"),[2] which defendant Merkin considered to be his "audit team," audited the Ascot, Gabriel and Ariel Funds (collectively, the "Funds") pursuant to engagement letters signed by Merkin. *See* Declaration of Malcolm T. Brown in Opposition to Defendants' Motions to Dismiss dated October 22, 2010 ("Brown Decl."), Ex. 16 at 112:20-23.[3] The BDO Defendants conducted audits of the Funds from their inception until December 11, 2008, the day that Bernard Madoff ("Madoff") confessed to running a $50 billion Ponzi scheme. ¶¶ 4-7, 29. As the BDO Defendants knew, Merkin invested 100% of the Ascot Fund and at least 25% of the Gabriel Fund and 25% of the Ariel Fund with Madoff through his investment firm Bernard L. Madoff Investment Securities, LLC ("BMIS"). Given the Funds' concentration of assets with Madoff, the BDO Defendants, at

[1] BDO, Tortuga and Binder together provided auditing services to Merkin, with BDO auditing and issuing audit opinions for his onshore entities, Ascot and Gabriel, and Tortuga and Binder, relying in whole or in part on BDO's audits, issuing audit opinions for the offshore fund, Ariel. ¶ 26-28.

[2] The BDO Defendants are BDO Member Firms that are under the management and control of BDO International, a governing body of a worldwide network of more than 1,000 public accounting firms in over 100 countries. ¶¶ 26-28.

[3] Merkin was deposed in the NYU Action referenced on p. 1 of the TAC. Plaintiffs can properly rely on his testimony in the NYU Action on this motion. *See Rothman v. Gregor,* 220 F.3d 81, 88-89 (2d Cir. 2000) (citing *Cosmas v. Hassett,* 886 F.2d 8, 13 (2d Cir. 1989) and *Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47-48 (2d Cir. 1991)) ("For purposes of a motion to dismiss, we have deemed a complaint to include any ... statements or documents incorporated in it by reference ... and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit").

a minimum, were required to verify those assets existed, which, to the detriment of the Plaintiffs and the Class, who collectively have suffered $2.4 billion in losses, ¶ 172, the BDO Defendants, in violation of their professional duties, egregiously failed to do.

As the independent auditor to Ascot and Gabriel, BDO represented in its annual audit reports that it had conducted GAAS (Generally Accepted Auditing Standards) compliant audits and that the financial statements of Ascot and Gabriel were presented in conformity with GAAP (Generally Accepted Accounting Principles). ¶¶ 180-82. Similarly, Tortuga and Binder represented in their annual audit reports that they had conducted ISA (International Standards on Auditing) compliant audits and that the financial statements of Ariel were presented in conformity with IFRS (International Financial Reporting Standards). ¶¶ 183-84. In all annual audit reports for the Funds, the BDO Defendants represented that they had examined evidence supporting the amounts and disclosures in the financial statements and that their audits provided them with a reasonable basis to conclude that the financial statements for the Funds were not materially misstated. These representations, however, were false. ¶¶ 26-28, 185, 241, 243-44.[4]

The BDO Defendants knew that the Funds could not have been successfully marketed to investors without a clean bill of health from an auditing firm of sufficient size and reputation to match the Funds' $500,000 and $1 million minimum initial subscriptions.. *See* Brown Decl., Ex. 7 at 4, Ex. 8 at 5, Ex. 12 at 7. Indeed, BDO markets itself by claiming that "A BDO audit lends credibility to a client's financial statements." *See* Brown Decl., Ex. 23. The BDO Defendants knew that Merkin and GCC would use the BDO brand to market the Funds and to provide

[4] While different auditing standards apply to the audits of the onshore (GAAS) and offshore funds (ISA), the standards are substantively similar in all material respects, ¶ 186, and the TAC cites to both sets of standards where possible. Thus, for purposes of this motion, references to "GAAS" shall be deemed to include "ISA," including with respect to specific auditing standards thereunder.

potential investors with the requisite comfort to invest, and, as alleged in the TAC, plaintiffs and members of the Class in fact relied on the BDO Defendants' audit reports in deciding to make their initial investments, and, in some cases, additional investments in the Funds. ¶¶ 26, 30, 245.

The BDO Defendants issued clean audit opinions on the Funds despite having actual knowledge, since at least the early 2000s, of facts strongly suggesting Madoff was likely running a Ponzi scheme – or, at a minimum, was reporting results that could not be achieved. As set forth in the NYAG Complaint,[5] Merkin admitted that "[t]here were over time persons who expressed skepticism about one or another aspect of the Madoff strategy or the Madoff return," and one of Merkin's most trusted colleagues specifically warned that Madoff could be running a Ponzi scheme. ¶ 126. *See* Brown Decl., Ex. 17, ¶¶ 102-03. This suspicion was largely based on the lack of volatility in Madoff's reported returns, ¶ 126, which is the same concern that caused numerous other financial professionals to refuse to entrust their clients' assets to Madoff. ¶¶ 149-55.

Merkin testified that he specifically discussed these concerns about Madoff with the BDO Defendants:

> Q. ***When Mr. Teicher raised the issue about the volatility of Mr. Madoff's returns, did you discuss those issues with any outside professionals, and by that I mean BDO Seidman or financial analysis firms or outside financial analyst experts?***
>
> A. ***I certainly had a conversation with one or two people at BDO Seidman, I am not sure they were on the audit side of BDO, but they worked on the strategy, they knew what we were doing*** and they from time to time recommended investors to the strategy because they thought it might make some sense for another existing client of theirs.

[5] The "NYAG Complaint" refers to the complaint filed in *Cuomo v. Merkin*, Index No. 450879/09 (Sup. Ct. N.Y. Co. Apr. 6, 2009) ("NYAG Action").

* * *

"A. ***[T]hese were persons at BDO Seidman who were involved with our account, who were familiar with the strategy, familiar with the returns, familiar with the risks*** and who on a rare occasion, but from time to time called and said could they recommend the strategy to an existing client of theirs".

* * *

Q. Who did you talk to at BDO about the Madoff strategy? ...

A. Would have been a gentleman by the name of Michael Andreola,

* * *

Q. When did that discussion with Mr. Andreola occur? ... A. [M]y guess is it is probably in the early 2000s".

See Brown Decl., Ex. 16 at 106:11-19, 108:23 – 109:8.

Thus, the BDO Defendants were told by their very own client of the "risks" of Madoff's supposed trading strategy and the serious questions regarding his purported returns. Nonetheless, they failed to obtain sufficient audit evidence of a single transaction or trade reported by Madoff, or the existence of the Treasury securities held by Madoff belonging to the Funds, and otherwise failed to investigate further, and instead issued clean audit reports year after year.

The risks of Madoff's trading strategy and his suspect returns were not the only "risks" concerning Madoff that BDO knew about or had access to. Because Madoff was not only an investment advisor to the Funds, but also the broker and custodian of the Funds' assets, ¶ 214, BDO knew there was a significant danger since the separation of the three functions generally operate as "checks and balances" to safeguard client assets in the hedge fund industry. ¶ 215. Further, according to the NYAG Complaint, Merkin told an investor that he required BDO to visit Madoff's offices two or three times a year to perform operational due diligence. ¶ 206. During this purported operational due diligence, BDO would have reviewed the books and

records of Madoff and also seen that most of the key positions at BMIS were held by Madoff's family members. ¶ 125. Merkin also testified that it was "entirely possible" that a May 2001 MAR/Hedge article which questioned the consistency of Madoff's returns and his secrecy concerning his strategy or success, "went to BDO." *See* Brown Decl., Ex. 16 at 145:8-14. The lack of transparency should have raised, from an auditor's perspective, suspicions about Madoff's trading and recordkeeping, especially given Madoff's "triple" role as investment advisor, broker and custodian of the Funds' assets.[6]

Whether or not BDO actually visited Madoff's offices as Merkin claimed, BDO had to know BMIS's books and records were audited by Friehling & Horowitz ("F&H"), a tiny accounting firm consisting of one retired accountant living in Florida, one 47 year old CPA, and a secretary, located in a 13' by 18' office in a strip mall in Rockland county. As one of the biggest accounting firms in the world, BDO had to know F&H could not possibly have the resources or experience necessary to audit a firm the size of BMIS that employed a complex hedging strategy involving tens of thousands if not hundreds of thousands of trades by S&P 100 stocks and an equal number of trades of puts and calls of the S&P Index options on the Options Exchange or over the counter. ¶ 208. These facts should have been sufficient to put BDO on "red alert."

Moreover, according to Merkin, his operation would produce daily, monthly, quarterly and year-to-date profit and loss statements, ¶¶ 87-88, based on paper trade tickets sent by Madoff, all of which were available to BDO. In fact, "Audit Inventory Reports" were prepared and given to BDO listing the stock purchases and sales purportedly made by Madoff with BDO

[6] While the Ariel Fund previously had an administrator, more than 25% of its assets that were managed by Madoff were in his custody, not in the custody of the administrator.

personnel, *see* Brown Decl., Ex. 16 at 116:19 – 118:14, 122:22-16, 123:20-22, 124:7-13, as well as options on those stocks, and, later, when Madoff's trading strategy changed, to options on the S&P 100 index ("OEX"). BMIS also sent monthly statements to Merkin, which the BDO Defendants, as the Funds' auditors, had to have seen in the course of their audits. Those trade tickets and monthly statements clearly showed that the trades Madoff reported were, in many instances not confirmed by the high/low prices for those securities as reported by the various exchanges.

Madoff's method of reporting to Gabriel Capital Corporation ("GCC") on the Funds' accounts should have alerted the BDO Defendants that there was a material risk of misstatement in GCC's financial reports. BMIS, a broker-dealer that pioneered electronic trading and was a major market-maker for stocks and options, mailed ***paper trade tickets*** to Merkin, instead of providing real-time electronic access to the Funds' accounts. ¶¶ 45, 199. As auditors with expertise in auditing hedge funds, the BDO Defendants should have instantly recognized that this archaic practice would allow Madoff to report fictitious results and was thus a glaring red flag. ¶ 199. Further, financial professionals who saw the trade tickets and BMIS' account statements easily recognized that Madoff always seemed to be buying and selling securities at the right time, and, in many instances, at prices outside the trading range for those securities. ¶¶ 200, 202. Evidence of this uncanny consistency was equally available to BDO. Had the BDO Defendants adequately fulfilled their responsibilities as auditors and performed a sampling of the transactions reflected in the trade tickets, which were date-stamped, against readily available actual trading prices on those days, they too would have recognized this as a warning sign of potential fraud. ¶ 153.

Moreover, the BDO Defendants knew or were reckless in not knowing that the volume of Madoff's purported options trading was impossible. ¶ 202. Merkin testified that he discussed the issue of whether the S&P 100 option market was large enough to handle Madoff's investment strategy with BDO personnel, *see* Brown Decl., Ex. 16 at 138:3-19, another one of the "risks" that was undoubtedly part of the mix of information the BDO Defendants had from Merkin about the Funds' investments with Madoff. As alleged in the TAC, this was another risk that was obvious to many, ¶¶ 150-151, but ignored by BDO.

The BDO Defendants knew that the Funds lacked appropriate internal controls in that the only information about the Funds' assets invested by Madoff came from BMIS, without any verification. ¶ 198. As the TAC alleges, because of "[t]he inherent risk for an assertion about a derivative or security is its susceptibility to a material misstatements," ¶ 192 (citing AU § 332.08), the BDO Defendants should have used substantive procedures, including, among others, confirming the transaction with the issuer of the entity, confirming with the holder of the security to the counterparty to the derivative, confirming settled transactions with the broker-dealer or counterparty and physically inspecting the security or derivative contract. *Id.* (citing AU § 332.21). If BDO attempted to inspect a derivative contract and sought confirmation from a counter-party, as required by applicable professional standards, it would have discovered the reported transaction did not exist. Indeed, as detailed in the SEC OIG Report, a single phone call to the DTC would have confirmed that Madoff had not executed a single trade for any client. ¶ 230. In addition, as alleged in the TAC, Madoff purported to close out his securities transactions at the end of each quarter and each year and placed the Funds' assets in Treasuries. ¶¶ 204. Thus, Madoff was able to avoid reporting large securities positions, which was another red flag ignored by BDO especially in light of Merkin's testimony that BDO was familiar with Madoff's

trading strategy which was dependent on entering and exiting the market at just the right times. ¶¶ 207. Even though BDO could have easily corroborated the existence or absence, as was the case here, of the Treasuries by requesting confirmations from the depository or clearing institutions at which book entries for these assets would have existed, it did not. ¶ 204.

Indeed, the BDO Defendants should have treated BMIS as a "service organization" because its services were part of the Funds' information system for derivatives and securities, ¶ 212, and thus they were required to assess the controls put in place by BMIS. ¶ 213 (citing AU § 332.11). Because BMIS initiated the securities transactions, held and serviced the securities as custodian for the Funds and prepared trading and account information, the BDO Defendants were required to perform additional procedures to opine on the financial statements, including site visits to inspect documentation, and identification of controls by the service organization. ¶¶ 214-15 (citing AU §§ 332.16, 332.18-20). They had an obligation to review the reports of the independent auditor of BMIS for the relevant period, (AU §§ 324.02, 324.12, 332.14), and discuss the result of its most recent audit of BMIS. ¶ 216 (citing AU § 324.19; *see also* AU §§ 324.02, 324.12, 324.14). Because Madoff liquidated all his accounts and placed their assets in Treasuries at year-end, in order to conduct a proper audit of BMIS, F&H would have had to allocate the Treasuries to each of Madoff's accounts based on the securities held in each account prior to its liquidation. ¶ 208. As detailed in the SEC OIG Report, within a "few hours" of getting F&H's work papers, it was obvious that F&H did not audit BMIS. ¶ 220.

In sum, the BDO Defendants' representations that they had conducted GAAS and ISA compliant audits and that the financial statements of the Funds were presented in conformity with GAAP and IFRS were patently false. Even in the face of serious indications of material misstatements in the Funds' financial statements, and of fraud at the Funds and at BMIS, the

BDO Defendants failed or refused to act in accordance with applicable auditing standards and continued to issue clean audits opinions. Accordingly, the BDO Defendants were active participants in Merkin's fraud on the Funds' investors.

Finally, as disclosed by the receiver[7] for the Gabriel and Ariel Funds, BDO, BDO Tortuga, Merkin and GCC had indemnity agreements as service providers that "purport to hold one or both of the Funds responsible for losses (including legal fees and expenses) sustained by the service providers in connection with any claims arising out of their performance of various services for the Funds, subject generally to carve-outs for willful misconduct and recklessness." The receiver disclosed that BDO and BDO Tortuga had already "asserted unliquidated indemnity claims against both Funds." *Id.* Ex. 19, ¶¶ 18-19 (emphasis added). Because BDO and BDO Tortuga, like Merkin and GCC, bargained for and obtained indemnification by the Gabriel and Ariel Funds, they should not be considered "independent" auditors of the Funds, and consequently, as they recognized but did not disclose to investors, they were not independent auditors of the Funds' financial statements. ¶ 224.

ARGUMENT

I. THE TAC SUFFICIENTLY STATES EXCHANGE ACT CLAIMS

The BDO Defendants' challenges to the sufficiency of the reliance and scienter allegations[8] in support of Plaintiffs' 10(b) claims against them fail for the reasons set forth below.[9]

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[7] On June 10, 2009, a stipulation and order was entered in the NYAG Action which, *inter alia*, appointed Bart M. Schwartz as receiver for the Gabriel and Ariel Funds. ¶ 177. *See* Brown Decl., Ex.18.

[8] BDO does not dispute Plaintiffs' standing to assert claims here as "purchasers and sellers" of the Funds' securities. *See* BDO I Mem. at 4.

A. The TAC Adequately Pleads Reliance

Reliance "requires a showing that 'but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction.'" *Varghese v. China Sheghuo Pharm. Holdings, Inc.*, 672 F. Supp. 2d 596, 605 (S.D.N.Y. 2009) (citing *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005)). BDO argues that the TAC fails to plead reliance because it does not allege that Plaintiffs "received [its] audit reports before investing in the funds or that they relied upon such reports in deciding to invest in the funds." BDO I Mem. at 4. This argument is contradicted by the allegations of the TAC which clearly state that (a) BDO issued audit reports on the annual financial statements of the Ascot, Gabriel and Ariel Funds which were relied on by Plaintiffs and other class members," ¶ 26; (b) BDO "knew that [its] audit reports would be ... made available to potential investors ... [and] existing and potential investors would rely on [them] ..." ¶ 30; and (c) "[a]s a direct and proximate result of [BDO's] wrongful conduct ... Plaintiffs and the other members of the Class suffered damages in connection with their respective purchases and sales of limited partnership interests" and that "BDO Defendants knew that *investors* would rely upon the audited financial statements of the Funds in making their investment decisions". ¶ 245. The BDO Defendants allowed Merkin to disclose in the Funds' prospectuses and confidential offering materials provided to potential investors that they were the auditors for the Funds. ¶¶ 30, 178-79. *See, e.g.*, Brown Decl., Ex. 7 at 10, 53, Ex. 8 at 13, 51, Ex. 12 at 18, 59. Because the Funds, as unregulated hedge funds, were not required to have their financial statements audited, the clean audit opinions were used to

(...continued)

[9] For the legal standards applicable to Exchange Act claims, *see* Merkin Opp'n at 15.

attract and retain investors. The BDO Defendants cannot credibly dispute that they knew potential and existing investors would rely on the fact that the fifth largest accounting firm in the world put its imprimatur on the financial statements of the Funds by issuing clean audit reports. ¶¶ 26-30, 245, 254, 277, 279, 284. Indeed, BDO marketed itself to the investment community on its representation of many investment fund clients and that its audits lend credibility to their operations. *See* Brown Decl. Ex. 23.

B. The TAC Adequately Pleads Scienter

In order to sufficiently plead scienter against an auditor, a plaintiff "must allege that 'the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decision if confronted with the same facts.'" *Varghese,* 672 F. Supp. 2d at 609-10 (quoting *In re Scottish Re Group Sec. Litig.,* 524 F. Supp 2d. 370, 398 (S.D.N.Y. 2007)). "[A]llegations of a recklessly performed audit will approximate intent." Id.; *see also In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008) (denying motion to dismiss based on auditor's alleged reckless conduct). Motive and opportunity are not required to plead a strong inference of scienter by an auditor. *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 189 (2d Cir. 2009).

Although "[t]he standard for pleading auditor scienter is demanding," the pleading standard is not an impossible one. *In re Refco, Inc. Sec. Litig.,* 503 F. Supp. 2d 611, 657 (S.D.N.Y. 2007) (quoting *In re Marsh & McLennan Cos. Sec. Litig.*, 501 F. Supp. 2d. 452, 488) (internal quotations omitted). The TAC need only "'supply some factual basis for the allegation' that [the auditor] had knowledge of the alleged fraud." *Whalen v. Hibernia Foods PLC*, No. 04 Civ. 3182, 2005 U.S. Dist. LEXIS 15489, at* (S.D.N.Y. Aug. 1, 2005) (citing *Rothman*, 220

F.3d at 91). "Allegations of 'red flags,' when coupled with allegations of GAAP and GAAS violations, are sufficient to support a strong inference of scienter." *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 240 (S.D.N.Y. 2004) (citing *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 334 (S.D.N.Y. 2001). Here, the TAC alleges detailed facts that show that the BDO Defendants' audits of the Funds, given what they knew about the known "risks" of investing with Madoff and other red flags about Madoff, were so "deficient that the audit amounted to no audit at all." *Varghese*, 672 F. Supp. 2d at 610.

1. The TAC Alleges Numerous Red Flags Coupled with GAAS Violations That Support a Strong Inference of Scienter

a) BDO was Aware of Red Flags

As set forth above, BDO was indisputably aware of red flags concerning the implausibility and impossibility of Madoff's returns. Merkin discussed with BDO warnings he personally received about Madoff's returns and the possibility that BMIS was a Ponzi scheme. As the TAC alleges, Merkin testified that: (1) he had a conversation with Michael Andreola, a BDO partner, concerning warnings he had received about the implausibility of Madoff's returns, including that "Madoff's returns were too good to be true"; (2) BDO was familiar with the "risks" of Madoff, strategy and its purported returns; and (3) BDO "knew what we [(the Funds)] were doing." (¶¶ 126, 207). *See* Brown Decl., Ex. 16 at 105:9-24, 106:11-14. Merkin's statements alone constitute a red flag that should have been viewed as a serious risk of fraud or indication of fraud, that, at a minimum, should have prompted a reasonable auditor to "investigate the doubtful." *See Varghese*, 672 F. Supp. 2d at 609-10. This red flag, coupled with BDO's knowledge that 100% of the Ascot Funds' assets and at least 25% of the Gabriel and Ariel Fund's assets were invested with Madoff, and that the Funds lacked internal controls because the *only* information about Madoff's supposed investment of the Funds' assets came

from BMIS in the form of monthly statements and trade tickets, without independent verification by Merkin should have placed BDO on notice of potential material misstatements or even fraud to the serious detriment of the Funds' investors.

Any other reasonable auditor after being advised by their client that he had received warnings that Madoff's returns were implausible or impossible, knowing that the assets of the funds the client was managing were concentrated at BMIS, *at the very least*, would have carefully reviewed the back-up materials for those Funds' financial statements, and confirmed the transactions reflected therein on a test basis. That review would have either verified the existence of the investments or confirmed the fraud. ¶¶ 198-200, 217-22. Here, BDO did not conduct itself like any reasonable auditor. It disregarded the red flags concerning the implausibility of Madoff's returns. It failed to verify that Madoff actually invested the assets of Ascot and Gabriel Funds by seeking confirmations from third parties, for example, by making a simple request to examine a derivative contract or contacting a counterparty. Despite indisputably knowing of suspicions about Madoff's returns, it did not compare the price of securities as reflected in trade tickets or account statements versus actual trading prices, or conduct any other investigation. [10]

[10] BDO argues that it satisfied its duty under GAAS, pursuant to AU 332.21, by confirming "the existence of [the Funds'] securities [purportedly held] with Madoff." BDO I Mem. at 21. However, an "auditor must consider the competency and sufficiency of the audit evidence, and, because, audit evidence is gathered and evaluated throughout the course of the audit, an auditor must have professional skepticism throughout the audit." ¶ 192. Especially given its knowledge of red flags, BDO had a duty to do more than rely on Madoff's work to confirm that he actually invested and held the Funds' assets. Had it even attempted to consider the "competency and sufficiency" of the audit evidence, it would have discovered that Madoff would not even allow access to his books and records, a sure sign that something was amiss.

While the BDO Defendants represented in their audit opinions that "audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements," ¶¶ 180, 183, the BDO Defendants clearly did not do so here, or, if they did, were extremely reckless, because they opined, year after year, that the Funds' financial statements fairly represented the Funds' financial condition when all or a significant portion of the Funds' assets did not exist at all. Thus, BDO's disregard of known red flags coupled with GAAS violations is sufficient to establish the culpable mental state of recklessness, approximating an actual intent to aid in the fraud. *See Varghese,* 672 F. Supp. 2d at 610 (citations omitted); *Whalen,* 2005 U.S. Dist. LEXIS 15489, at 10* (S.D.N.Y. Aug. 1, 2005) (allegations that auditor knew about and ignored red flags should have put auditor on notice that "fraud was afoot," and were sufficient to establish scienter); *see also In re Winstar Commc'ns,* 01 Civ. 3014, 2006 U.S. Dist. LEXIS 7618, at *37 (S.D.N.Y. Feb. 27, 2006).

Thus, this case is imminently distinguishable from those cited by BDO in support of its argument that the TAC does not allege facts to support a strong inference of scienter. Indeed, in each of the cases cited, while plaintiffs there had alleged GAAP violations, the court found that they failed to plausibly allege facts to show that the auditors had knowledge of specific red flags. *See Stephenson v. PricewaterhouseCoopers, LLP,* 700 F. Supp. 2d 599, 624 (S.D.N.Y. 2010)(emphasis added) ("Aside from the allegation at the outset ... describing the red flags ... PWC is not plausibly alleged to have knowledge of specific red flags. Granted, the complaint alleges facts sufficient to support the conclusion that certain suspicious facts surrounded Madoff's operation, but the complaint does not connect those red flags to PWC through factually sufficient allegations that PWC ***actually knew of or uncovered them***"); *Meridien Horizon Fund, LP v. Tremont,* 09 Civ. 3708, 2010 U.S. Dist. LEXIS 32215, at *15, *17 (S.D.N.Y. Mar. 31,

2010)(citations omitted) ("A complaint might reach the 'no audit at all threshold' by alleging that the auditor disregarded specific 'red flags' that would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors. Under this framework, however, merely alleging that the auditor had access to the information by which it could have discovered the fraud is not sufficient ....Here, "plaintiffs fail to allege that KMPG or KMPG Cayman was aware of any ... concrete facts indicative of Madoff's fraud"). Cases decided since BDO's motion to dismiss apply the same standard. *See Anwar II,* 2010 U.S. Dist. LEXIS 86716, at *212 (citing *Stephenson, supra*) (finding that plaintiffs "fail[ed] to allege that the PwC Member Firms were sufficiently aware of the red flags cited in the SCAC"); *In re Beacon Assocs. Litig.,* 09 Civ. 777, 2010 U.S. Dist. LEXIS 106355, at **69-70 (S.D.N.Y. Oct. 5, 2010) (alterations added and in original) ("[T]here is no allegation that BAMC was actually aware of the publicly available red flags. As other courts to consider similar red flag allegations in the aftermath of the Madoff affair have found, '[P]laintiffs do not allege that Markopoulos ever discussed his assessment that Madoff was operating a Ponzi scheme with [Defendants] or ... that Madoff's returns could not be replicated").

Here, in contrast, the BDO Defendants were informed of and discussed with Merkin concrete concerns regarding the implausibility of Madoff's returns, and were familiar with the Madoff strategy, its returns and risks, what the Funds were doing in terms of the investment strategy with Madoff, and the risks associated with Madoff and the alleged auditing of Madoff by the storefront accountant (¶¶ 126, 207), and recklessly disregarded the same.[11]

[11] BDO's reliance on *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405 (S.D.N.Y. 2007), *aff'd, South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009) ("*South Cherry*") is unavailing for the reasons set forth in Merkin Opp'n, at 27-29.

b) BDO Recklessly Disregarded Knowable Red Flags

The BDO Defendants also had access to red flags[12] that would have put a reasonable accountant on notice of significant deficiencies with the financial reporting of the Funds. ¶¶ 196-210. *See, e.g., IMAX,* 587 F. Supp. 2d at 485 ("although ... plaintiffs [] do [not] allege that PWC actually reviewed ... the various documents ... that could have revealed if IMAX was violating its own accounting policy, we find the inference that PWC reviewed such documentation and thus was reckless in not detecting the alleged violations strong enough for the case against PWC to proceed for now"); *In re WorldCom Inc. Sec. Litig.*, 02 Civ. 3288, 2003 U.S. Dist. LEXIS 10863, at *22 (S.D.N.Y. June 25, 2003) ("[h]ad Andersen reviewed WorldCom's accounting systems and data, as it was obligated to do, it would have discovered the lack of documentation and the fraudulent accounting treatment."). Here, the BDO Defendants ignored serious red flags that they knew "would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors." *IMAX,* 587 F. Supp. 2d at 483 (citing *In re AOL Time Warner Sec. & ERISA Litig.,* 381 F. Supp. 2d 192, 240 n.51 (S.D.N.Y. 2004)). The BDO Defendants' discussions with Merkin and his staff, access to the books and records of the Funds, as well as to industry and other information, supports a strong inference of scienter. The red flags included:

- Madoff always appeared to be purchasing and selling securities at the right time, a consistency that others, with less access to information than the BDO Defendants, concluded was indicative of fraud. In addition, many monthly account statements and trade tickets showed trades in certain securities that were allegedly executed at prices outside the daily range of prices for such securities traded in the market on the days in question. ¶¶ 200-02.

[12] Red flags are facts that "would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriments of its investors." *IMAX,* 587 F. Supp. 2d at 483-84.

- Madoff's investment strategy was suspect.

- Madoff acted as the investment advisor, the broker and the custodian of the Funds. There was no third party administrator or custodian to verify the existence of the Funds' assets. ¶¶ 203, 214, 217.

- According to Merkin, BDO visited with Madoff and consequently would have seen the lack of books and records of Madoff and that many of the top posts were held by Madoff relatives.

- Madoff's operations were opaque. Merkin testified that it was "entirely possible" that he gave BDO the 2001 Mar/Hedge article raising concerns about his secrecy about his strategy or returns. Further, as professionals in the financial industry, and, as auditors of hedge funds invested with Madoff, members of BDO's audit team likely read the 2001 Barron's article that also reported similar concerns about Madoff.

- BMIS was audited by F&H. Madoff's own financial statements were audited by an obscure one man storefront CPA accounting firm with no other clients. ¶¶ 208, 217.

- The trading confirmations and monthly statements from Madoff were suspect. While BMIS, as a broker-dealer, clears trades electronically, investors had no electronic real-time access to their accounts. Further, BMIS provided paper trading tickets, instead of contemporaneous electronic trade confirmations. ¶ 199.

- There were not enough options trading on the exchanges or over the counter to support Madoff's purported trading activity. As early as 1997 and 1998, financial professionals recognized that Madoff could not be trading the volume of options to support his purported split-strike strategy.

- Madoff claimed to hold all of his investment advisory clients' assets in Treasuries at the end of each reporting period. This was an obvious means of concealing fraud, and inconsistent with Madoff's trading strategy. ¶ 204. But, the existence of these Treasuries was never confirmed by an independent source other than the same storefront account.

- Madoff did not have a standalone hedge fund. Madoff operated through managed accounts, rather than by setting up a hedge fund of his own, where his fees would have been much higher than the brokerage commissions he was charging.

These red flags, which "must be reviewed in the aggregate," *In re Phillip Serv.s Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 467-77 (S.D.N.Y. 2004), establish BDO's reckless auditing and

thus satisfy the pleading requirements for scienter. *See IMAX*, 587 F. Supp. 2d at 485 (allegations of auditor's recklessness in failing to detect red flags sufficient to establish scienter).

The BDO Defendants argue that, when they were auditing the Funds, they were not acting as forensic accountants and claim that this absolved them from using "tests to detect potential securities fraud in situations as this." BDO I Mem. at 8. This argument is a red herring. Plaintiffs are not claiming that the BDO Defendants should have acted as forensic accountants, only that, because they ***knew*** the Funds were entities with securities investments, they were required under GAAS to perform required special procedures because "[t]he inherent risk for an assertion about a derivative or security is its susceptibility to material misstatement, assuming there are no related controls." The BDO Defendants knew there were no "related controls" because Merkin did not have procedures in place to monitor or verify Madoff's investmentsThus, the BDO Defendants should have, among other things, employed "substantive procedures, such as confirming the transaction with the issuer of the entity; confirming with the holder of the security, including securities in electronic form, or with the counterparty to the derivative; confirming settled transactions with the broker-dealer or counterparty." (AU §§ 332.08, 332.21). BDO was reckless in not altering its audit procedures to comply with these professional requirements, especially since it was aware that the Ascot, Gabriel and Ariel Funds' financial reporting could have been seriously compromised by the questionable results reported by Madoff.

The BDO Defendants' related argument that they were "not even auditing the entity that was engaged in the financial fraud" (BDO I Mem. at 8) fails for the same reason. If they had audited the *Funds* in compliance with GAAS, they would have discovered that the trades Madoff purported to be making in the *Funds*' accounts did not exist. Thus, the BDO Defendants citation

to *Tremont,* 2010 U.S. Dist. LEXIS 32215, at *17, and *Stephenson,* 700 F. Supp. 2d at 624, both of which dismissed securities fraud claims against auditors based in part on the fact that the Funds' auditors were not engaged to audit BMIS (*see* BDO Mem. at 8-9) misses the mark. In both *Tremont* and *Stephenson,* the Court found that plaintiffs failed to allege that the auditors had knowledge of red flags associated with Madoff's strategy and returns that should have prompted further inquiry. *See Tremont,* 2010 U.S. Dist. LEXIS 32215, at *17; *Stephenson,* 700 F. Supp. 2d at 624. Here, BDO did have actual knowledge of serious deficiencies in the Funds' internal controls and thus serious problems with their financial reporting. *Varghese,* 672 F. Supp. 2d at 610.

Further, as alleged in the TAC and as recognized by tribunals and the NYAG, there is ample evidence that Merkin and GCC were engaging in fraud in connection with the Funds. For example, Merkin has been found liable in two arbitrations brought by Fund Investors. Further, in the NYAG Action, the court denied the motion to dismiss the NYAG's claims against Merkin and GCC for fraud in connection with the sale of securities in the Funds. *Cuomo v. Merkin,* Index No. 450879/09, 2010 N.Y. Misc. LEXIS 523, (Sup. Ct. N.Y. Co. Feb. 8, 2010). ¶ 176. Moreover, just two days ago, on October 20, 2010, the NYAG made a motion for summary judgment on his claims for fraud and breach of fiduciary duty against Merkin and GCC. Indeed, under AU § 34.01, "the auditor must obtain a sufficient understanding of the entity and its environment, including its internal controls, as to assess the risk of material misstatement of the financial statements, whether due to error or fraud," which would have required the BDO Defendants to review the Funds' offering materials. Had they done so, they would have seen that the representations in the Funds' offering materials concerning the management of the Funds' investments were entirely inconsistent with the fact that Merkin blindly entrusted all of

Ascot's assets and more than 25% of the Gabriel/Ariel Funds' assets to Merkin. Thus, the BDO Defendants were on notice of potential fraud in Merkin's management of the Funds.

c) The BDO Defendants' Knowing and Reckless GAAS Violations

Despite representing that they had conducted audits in compliance with GAAS, the BDO Defendants knew or were reckless in not knowing that their audits were not performed in accordance with GAAS. As set forth above, the BDO Defendants violated GAAS violations during the course of their audits of the Funds. As alleged in the TAC, BDO failed to comply with applicable professional standards, by failing, among other things, to (a) obtain reasonable assurances whether the Funds' financial statements were free of material misstatements, ¶ 190; use the requisite professional skepticism about Funds' financial results, ¶ 191; consider the possibility of fraud (*id.*); consider the competency and sufficiency of audit evidence (*id.*); use special procedures because the Funds were entities with securities investments, ¶ 192; treat BMIS as a service organization, ¶ 212; conduct onsite visits to BMIS ¶ 215; and corroborate BMIS' trades by seeking confirmations from counterparties or depository institutions ¶ 218. These serious GAAS violations, given the BDO Defendants' awareness of actual red flags and awareness of others, is sufficient to support a strong inference of scienter. *See Whalen*, 2005 U.S. Dist. LEXIS 15489 at *10.

2. No Plausible Competing Inferences

To plead a 10(b) claim, the inference of scienter based on the facts alleged "must be more than likely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc.*, 551 U.S. at 314. Here, the inference of scienter is certainly at least as compelling as any alternative offered by BDO, if not more. BDO argues that "the more compelling inference as to why Madoff's fraud went undetected for two decades

was his proficiency in covering up his scheme ...." BDO I Mem. at 9. That argument, however, again ignores the fact that Merkin was warned about the implausibility of Madoff's returns and the possibility that Madoff was a Ponzi scheme and discussed the warning with BDO.

Further, the SEC's incompetence in failing to uncover the fraud does not exonerate the BDO Defendants, nor is it dispositive of their scienter. *See* Merkin Opp'n at 32 n.13 (citing 15 U.S.C. § 78z) ("No action or failure to act by the [SEC] . . . in the administration of this title shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act . . . be deemed a finding by such authority that such statement or report is true and accurate on its face or that it is not false or misleading"). *See also Anwar II,* 2010 U.S. Dist. LEXIS 86716, at *84 ("[A]ny competing inference of innocent conduct – e.g., that the [defendants] were bamboozled by Madoff – is not as compelling as the finding of scienter. To discount Plaintiffs' allegations at this stage would be to wave away the [defendants'] exposure lasting almost two decades to the red flags and other markers of scienter").

II. SLUSA DOES NOT BAR PLAINTIFFS' STATE LAW CLAIMS

Plaintiffs' state law claims are not barred by SLUSA *See* Merkin Opp'n at 37-39.

III. PLAINTIFFS HAVE STANDING TO ASSERT THEIR STATE LAW CLAIMS

Plaintiffs have standing under New York law to assert their state law claims against BDO. Contrary to BDO's argument, BDO I Mem. at 11, lacks merit, Plaintiffs' state law claims are not derivative. First, this is not an action by the Funds' limited partners or shareholders against the Funds. It is an action by investors against the promoters, investment manager and auditors of the Funds who induced Plaintiffs to make and retain their investments in the Funds through fraudulent and other tortious activities. ¶¶ 3, 8-12, 20-21, 26, 29-30, 53, 245, 254-56,

261-63, 277-81, 284-88. BDO owed a duty to Plaintiffs as individual investors, regardless of whatever duties they owed to the Funds. *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *55. Second, as a matter of law, "allegations by investors of having been tortiously induced to invest or retain an investment are *not* derivative claims." *Id.* at *58 (citing *Pension Comm.*, 446 F. Supp. 2d at 205) (emphasis added). *See Stephenson*, 700 F. Supp. 2d at 611-12 ("Claims based on theories of fraudulent and negligent inducement "are direct because they allege a harm suffered by plaintiff independent of the partnership ..."); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC,* 376 F. Supp. 2d 385, 409 (S.D.N.Y. 2005) (quoting *Abrams v. Donati*, 489 N.E.2d 751, 751-52 (N.Y. 1985) and citing *Broome v. ML Media Opportunity Partners L.P.*, 709 N.Y.S.2d 59, 60 (1st Dep't 2000); *Strain v. Seven Hills Assocs.*, 429 N.Y.S.2d 424, 431-32 (1st Dep't 1980)) (applying the same rule to actions by limited partners against a partnership). Thus, "to the extent that Plaintiffs properly allege duties owed by [BDO] to them, they have standing to pursue such claims." *Anwar*, 2010 U.S. Dist. LEXIS 86716, at *56.

Contrary to BDO's claim, Delaware law does not control the issue of standing here. *See* BDO I Mem. at 12. BDO's contrary argument rests on a misapprehension of the "internal affairs" doctrine which "generally requires that 'questions relating to the internal affairs of corporations are decided in accordance with the law of the place of incorporation.'" *Pension Comm. of the Univ. of Montreal Penstion Plan v. Banc of Am. Sec., LLC,* 446 F. Supp. 163, 191 (S.D.N.Y. 2006) (quoting *Edgar v. MITE Corp.*, 457 U.S.624, 645 (1982)). The internal affairs of the Funds are not implicated by this action.[13] Moreover, in tort actions, New York courts

[13] Aside from the fact that the Ascot and Gabriel Funds are limited partnerships nominally incorporated in Delaware, they have no other connection to that State. Both the Ascot and Gabriel Funds list as their business addresses 450 Park Avenue, New York, NY, which is the same address as co-defendant GCC. (continued...)

employ an "interest analysis," where the law forum with the greatest interest in the action is applied. *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at **56-58 n.8. Here, the forum with the greatest interest is New York. *See* BDO II Opp'n at 11-12. And, with respect to Ascot and Gabriel limited partners, even "if the Court were to apply Delaware standing law to Plaintiffs' claims ... the result would be the same. ... [as] Plaintiffs have standing under Delaware law." *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at **58-59 n.9.[14]

Finally, Plaintiffs' state law claims are not based on a duty owed to the Ascot or Gabriel Funds. As stated by Judge Marrero in *Anwar*:

> At its core, *this case alleges claims against the corporate entities and individuals responsible for the representations that led Plaintiffs to make and maintain investments in the Funds* which, though nominally corporate, were mere vessels for ferrying the investments to Madoff. *The fraud and breaches of duty were essential to the Funds' corporate forms thriving as substantially all of the Funds assets were invested with Madoff. Ironically the alleged concealment or reckless ignorance by Defendants did not harm the Funds as such.* Rather, what the pleadings suggest is that Defendants' errors of omissions, committed under the spell of Madoff's profits, served as the lotus that kept Defendants blissful and that sustained their corporations. Without the fraud and other wrongs alleged in this action, the Funds would not have existed. The Court is not inclined to limit liability as to the corporate entity that allegedly functioned essentially as a vehicle for harming Plaintiffs.

(...continued)

Further, the Gabriel Fund has voluntarily consented to the appointment of a Receiver in New York: (1) for the ultimate distribution of proceeds to its respective investors; and (2) to manage, control and wind-down its operations." Brown Decl., Ex. 18 (Stip and Order Appointing Receiver) at 1, 2, 4. *See also* BDO II Opp'n. at 19-20 (explaining why the internal affairs doctrine is inapplicable to the Ariel Fund).

[14] In the partnership context, the "relationships among the parties may be so simple and the circumstances so clear-cut that the distinction between direct and derivative claims becomes irrelevant." *In re Cencom Cable Income Partners, L.P. Litig.*, No. C.A. 14634, 2000 WL 130629, at *3 (Del. Ch. Jan. 27, 2000). This is particularly so "where a partnership is in liquidation and *all* nondefendant partners in the resulting litigation constitute a uniform class of limited partners." *Id.* (emphasis in original); *see also Anglo Am. Sec. Fund, L.P. v. S.R. Global Int.'l Fund, L.P.*, 829 A.2d 143, 151 (Del.#Ch. 2003).

Id. at **59-60 (emphasis added) (citations omitted). As Judge Marrero's analysis makes clear, Plaintiffs' standing to assert each of their state law claims against BDO is based on: (1) injuries that are independent and distinct of any suffered by the Funds; and (2) breaches of duty independent of any owing to the Funds. Therefore, the motion to dismiss Plaintiffs' claims for lack of standing should be denied.

IV. PLAINTIFFS HAVE SUFFICIENTLY STATED A COMMON LAW FRAUD CLAIM

In New York, the elements for a claim of common law fraud are: "(1) a material representation or omission of fact; (2) made with knowledge of its falsity; (3) with scienter or an intent to defraud; (4) upon which the plaintiff reasonably relied; and (5) such reliance caused damage to the plaintiff." *Bui v. Indus. Enter. of Am., Inc.,* 594 F. Supp. 2d 364, 371 (S.D.N.Y. 2009). "As these elements are substantially identical to those governing § 10(b), the identical analysis applies." *Anwar II,* 2010 U.S. Dist. LEXIS 86716, at *98 (internal quotations omitted). *Accord Fraternity Fund, Ltd.,* 376 F. Supp. 2d at 407. BDO's motion to dismiss Plaintiffs' common law claim for fraud should be denied for the reasons set forth in Section I, above.

V. PLAINTIFFS HAVE SUFFICIENTLY STATED A BREACH OF FIDUCIARY DUTY CLAIM

Under New York law, Plaintiffs may assert claims for breach of fiduciary duty against BDO on behalf of existing limited partners of the Funds.[15] *See White v. Guarente,* 372 N.E.2d 315, 318-19 (N.Y. 1977) (holding that although the limited partners were not parties to the

[15] BDO's argument that it "owes no fiduciary duty," BDO I Mem. at 15, misses the point. An auditor owes a fiduciary duty to the limited partners of an audit client that is a partnership. This is because the audit is intended for the benefit of the limited partners and because the auditor is supposed to be independent of the audit client.

retainer agreement, the accountant should have foreseen that a limited partner would rely on or make use of the audits).[16]

To hold an accountant liable to a party not in privity but who relies to his or her detriment on inaccurate financial reports, a plaintiff must show: "(1) that the accountants must have been aware of the financial reports were to be used for a particular purpose or purposes, (2) in the furtherance of which a known party or parties was intended to rely; and 3) there must be some conduct on the part of the accountant linking them to the party or parties, which evinces the accountant's understanding of that party's reliance." *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 115, 118 (N.Y. 1985). Plaintiffs have met these requirements here.

The TAC unequivocally pleads a breach of duty. The TAC alleges that the BDO Defendants "owed to Plaintiffs and the Class members a duty: (a) to act with reasonable care in preparing their audit reports of the financial statements of the Funds, which financial statements were relied upon by Plaintiffs and other Class members in deciding to purchase their limited partnership interests or shares; and (b) to use reasonable diligence in determining the accuracy of the information contained in the financial statements and in preparing the auditors' reports. ¶ 285. The TAC alleges that the BDO Defendants "breached [its] duties to Plaintiffs and other Class members by failing to investigate, confirm, prepare and review with reasonable care the information contained in the ... audited financial statements ... of the Funds." ¶ 286. It further alleges that the BDO Defendants' breaches of duty are evidenced by the financial statements of

[16] Although breach of fiduciary duty and negligence are separate claims, the analysis from *White*, which involved a negligence claim, applies to a breach of fiduciary duty claim inasmuch as "[a] cause of action for breach of fiduciary duty sounds in either intentional or negligent conduct." *Pergament v. Roach*, 18 Misc.#3d 1141A, 859 N.Y.S.2d 898 (Sup. Ct. N.Y. Co. 2008) (citing *Shapiro v. Rockville Country Club, Inc.*, 22 A.D.3d 657, 802 N.Y.S.2d 717 (2d Dep't 2005).

the Funds which "failed to reveal that the BDO Defendants had failed to probe the adequacy of Merkin's internal controls or the controls established by Madoff and BMIS, or the accuracy of the information received from Merkin and Madoff regarding the investments of the assets of the Funds." ¶ 287. Indeed, as set forth above, the TAC is rife with allegations of the BDO Defendants' rampant and repeated violations of GAAS over more than a decade, which are supported by Merkin's own testimony. *See* pp.4-10, *supra*. Accordingly, Plaintiffs have stated a valid breach of fiduciary duty claim against the BDO Defendants. *See SIPC v. BDO Seidman, LLP,* 222 F.3d 63, 74 (2d Cir. 2000).

VI. PLAINTIFFS HAVE SUFFICIENTLY STATED AN AIDING AND ABETTING BREACH OF FIDUCIARY DUTY CLAIM

A claim for aiding and abetting breach of fiduciary duty has three elements: "(1) a breach of fiduciary obligations to another of which the aider and abettor had actual knowledge; (2) the defendant knowingly induced or participated in the breach; and (3) plaintiff suffered actual damages as a result of the breach." *Kottler v. Deutsche Bank AG,* 607 F. Supp. 2d 447, 466 (S.D.N.Y. 2009) (citing *In re Sharp Int'l Corp.,* 403 F.3d 43, 49 (2d Cir. 2005)). BDO challenges only the first and second prongs of this claim, but their arguments lack merit.

A. Plaintiffs Allege Actual Knowledge

The TAC explicitly alleges that: "BDO Defendants knowingly disregarded information that indicated or should have indicated that the assets invested by Plaintiffs and the Class in the Funds were being invested with Madoff and BMIS and that Merkin and GCC did not have a genuine belief or a reasonable basis for the financial statements sent to Plaintiffs and the Class or for other statements made to Plaintiffs and other investors." ¶ 261. BDO knew of the warnings Merkin received concerning the implausibility of Madoff's returns. Merkin discussed those warnings with BDO. Moreover, according to Merkin, BDO was familiar with the Madoff

strategy, its returns and risks. ¶¶ 126, 207. BDO nevertheless did not verify that Madoff actually invested the assets of the Funds or that the Treasury Securities Madoff claimed were held for the Funds actually existed. ¶¶ 217-22. Thus, despite BDO's knowledge or reckless ignorance that its audits were not conducted in accordance with GAAS, and that the financial statements of the Funds were not free from material misstatement, it continued to issue unqualified audit opinions.

These facts are sufficient to allege actual knowledge.[17] At the very least, the allegations in the TAC establish conscious avoidance on the part of BDO, which is sufficient satisfy the knowledge prong of an aiding and abetting claim. *See Cromer Fin., Ltd. v. Berger,* 00 Civ. 2284, 2003 U.S. Dist. LEXIS 10554, at *28 (S.D.N.Y. Jun. 23, 2003) ("[T]here is no reason to believe that New York law would not accept willful blindness as a substitute for actual knowledge in connection with aiding and abetting claims"); *Fraternity Fund Ltd.,* 479 F. Supp. 2d at 368 (citations omitted) (" [T]he Court sees no reason to spare a putative aider and abettor who consciously avoids confirming facts that, if known, would demonstrate the fraudulent nature of the endeavor he or she substantially furthers"). Moreover, the allegations in the TAC that BDO disregarded numerous red flags should have triggered a heightened degree of professional skepticism that the financial statements of the Funds were materially misstated. *See Whitney v. Citibank, N.A.,* 782 F.2d 1106,#1115-16 (2d Cir. 1986).

[17] Whether actual knowledge has been appropriately alleged is, as a general matter, not appropriate for determination on a Rule 12(b)(6) motion. *See, e.g., Am. Baptist Churches v. Galloway,* 710 N.Y.S.2d 12, (1st Dep't 2000) (whether plaintiffs adequately alleged actual knowledge for aiding and abetting breach of fiduciary duty claim require discovery and, thus, was not ripe for determination on Rule 12(b)(6) motion).

B. Plaintiffs Allege Substantial Assistance

A person knowingly participates when he or she provides "substantial assistance" to the primary violator. *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 294 (2d Cir. 2006). "One provides substantial assistance if he 'affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables it to proceed.'" *Kolbeck v. LIT Am., Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996) (quoting *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 284 (2d Cir. 1992)). The TAC also alleges that BDO "provided substantial assistance to this fiduciary breach by issuing clean audit opinions that were prepared in clear violation of GAAP and GAAS." ¶ 262.

Merkin, as the general partner of Ascot and Gabriel, and the owner of GCC, the investment advisor to Ariel, is alleged to have "deceived [Plaintiffs] into believing that [the Funds] would be properly managed, with proper oversight." *Nathel v. Siegal,* 592 F. Supp. 2d 452, 470 (S.D.N.Y. 2008) (alterations added and in original). BDO provided substantial assistance to this fiduciary breach by issuing clean audit opinions that were prepared in clear violation of GAAP and GAAS. ¶ 262. BDO did this by actively concealing that Merkin and GCC did not have a genuine belief or a reasonable basis for the financial statements sent to Plaintiffs or for other statements made to investors. ¶ 261. Accordingly, the TAC sufficiently alleged substantial assistance.

VII. PLAINTIFFS HAVE SUFFICIENTLY STATED AN UNJUST ENRICHMENT CLAIM

BDO's argument that Plaintiffs "are not the proper parties to bring an unjust enrichment[18] claim claim because they did not pay the [auditing] fees and thus were not damaged directly" (BDO I Mem. at 17), is contradicted by the the Funds' offering documents. The March 2006 Ascot Fund offering memorandum provides, for example, that all costs, fees, operating expenses and other expenses be paid by the Partnership (*see* Brown Decl., Ex. 7 (2006 Ascot Offering Memo) at 15), but such expenses, were allocated among the partners in proportion to their respective capital accounts for each accounting period. *Id.* Each partner ultimately paid BDO's fees. *See* Brown Decl., Ex. 8 at 18-19; Ex. 12 at 28-29. Thus, as Plaintiffs and the Class ultimately bore the expense of BDO's fees, they are the proper parties to bring this claim.

BDO's argument that Plaintiffs' claims should be dismissed "because it seeks a duplicate recovery" (BDO I Mem. at 17) is no more availing. Plaintiffs' tort claims against the BDO Defendants seek to hold them liable for injuries suffered as a result of representations that induced Plaintiffs to make investments in the Funds, and, with respect to the breach of fiduciary duty claim, to hold those investments. Notably, the BDO Defendants entered into indemnity agreements with the Funds to claw back any monies that may be paid to Plaintiffs in connection with their negligence-based tort claims. (¶ 224); see Brown Decl., Ex. 19, ¶¶ 18-19. Plaintiffs' unjust enrichment claim is an equitable remedy to disgorge BDO from any and all ill-gotten gains in connection with those ill-gotten gains and ensure that Plaintiffs are made whole.

[18] To sustain a claim for unjust enrichment, a plaintiff must establish: "(1) that the defendant was enriched; (2) that the enrichment was at the plaintiff's expense; and (3) that the circumstances are such that in equity and good conscience the defendant should return the money or property to the plaintiff." *Golden Pac. Bancorp v. FDIC,* 273 F.3d 509, 519 (2d Cir. 2001).

Therefore the motion to dismiss Plaintiffs' claim for unjust enrichment should be denied.

VIII. PLAINTIFFS HAVE SUFFICIENTLY STATED A NEGLIGENT MISREPRESENTATION CLAIM

The BDO Defendants' only real challenge[19] to this claim is that Plaintiffs failed to satisfy the *Credit Alliance* standards for auditor liability, which, as set forth below, is incorrect as a matter of law.

A. Plaintiffs Allege a Relationship Approaching Privity with BDO

In *Credit Alliance,* the New York Court of Appeals held that accountant's liability extends to third parties with whom there is a relationship "sufficiently approaching privity." 483 N.E.2d at 119. *Accord BHC Interim Funding, L.P. v. Finantra Capital, Inc.,* 283 F. Supp. 2d 968, 984 (S.D.N.Y. 2003) (quoting *Parrott v. Coopers & Lybrand,* 741 N.E.2d 506, 508 (2000)). To establish a relationship approaching privity: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance." *Credit Alliance,* 483 N.E.2d at 118. BDO's argument that these factors are not met fails.

[19] While the BDO Defendants also argue that Plaintiffs failed to establish a breach of fiduciary duty (because they purportedly did not violate GAAS), a *breach* of a fiduciary duty is not an element of this claim, and, in any event, Plaintiffs have sufficiently alleged GAAS violations. *See* p. 22, *supra.* Furhter, the BDO Defendants' argument that Plaintiffs failed to allege reliance on the alleged misrepresentations is demonstrably wrong.

1. BDO Knew that its Audit Reports Were to be Used for a Particular Purpose

BDO knew that all of the assets of the Ascot Fund and at least 25% of the assets of the Gabriel Fund were invested with Madoff. ¶¶ 128, 196. It knew that the investments of investors in the Ascot and Gabriel Funds depended, in substantial part, on how their investments with Madoff performed. Further, as the only auditor ever engaged to conduct audits of Ascot and Gabriel, ¶ 29, BDO knew it was the sole source available to verify the investment of those Funds' assets with Madoff and validate the veracity of their financial statements.

BDO also "knew that Merkin would use its name to market the Ascot and Gabriel Funds," and that its "audit reports would be provided to existing investors and would be made available to potential investors." Additionally, it was fully aware that "existing and potential investors would rely on the fact that a global auditing firm was the auditor of the Funds, had conducted proper audits of the Funds, and issued clean audit reports for the Funds." ¶¶ 30, 278. *Cf. United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n. 14 & 15 (1984) ("The inclusion in an audited financial statement of anything less than an unqualified opinion could send signals to stockholders, creditors, potential investors, and others that the independent auditor has been unable to give the corporation an unqualified financial bill of health. Such a public auditor's opinion could well have serious consequences for the corporation and its shareholders") ("Public faith in the reliability of a corporation's financial statements depends on the public perception of the outside auditor as an independent professional"). Consistent with its knowledge, BDO addressed its audit reports to the partners of Ascot and Gabriel, and to the shareholders of Ariel. ¶¶ 180-82.

2. Plaintiffs Were Known Parties to BDO

BDO does not challenge that existing and potential investors in the Ascot and Gabriel Funds were known parties who would rely on the audit reports for their intended purpose, nor can it. *Anwar #,* 2010 U.S. Dist. LEXIS 86716, at **224-25. Rather, BDO makes the nonsensical argument that the TAC fails to allege Plaintiffs relied on the audit reports in deciding to invest in Ascot and Gabriel in the first instance and, thus, are incapable of establishing reliance. *See* BDO I Mem. at 18 (The TAC "avers that plaintiffs received the audited financials after they had already made their investments ... yet plaintiffs sue only for having been induce to make the investment in the first place.") ("Plaintiffs' failure to allege that their decision to invest was dependent upon the audited financials also means that they fail to allege the requisite element of reliance). This argument is patently false. Among other things, the TAC clearly alleges that BDO "owed to Plaintiffs and the Class members a duty ... to act with reasonable care in preparing their audit reports of the financial statements of the Funds, *which financial statements were relied upon by Plaintiffs and other Class members in deciding to purchase their limited partnership interests* ... and ... to use reasonable diligence in determining the accuracy of the information contained in the financial statements and in preparing the auditors' reports." ¶ 285 (emphasis added).

3. There Was Sufficient Linking Conduct Evincing BDO's Understanding of Plaintiffs' Reliance

BDO does not make any argument addressing linking conduct. Sufficient linking conduct has been alleged here.

Thus, as in *Anwar II,* this Court should deny BDO's motion to dismiss Plaintiffs' negligent misrepresentation claim* based on an alleged lack of duty.

IX. PLAINTIFFS SHOULD BE ALLOWED TO AMEND THE TAC IF NECESSARY

Plaintiffs submit they are entitled to replead to cure any deficiency the Court may find in the TAC with respect to any Defendant. *See* BDO II Opp'n, Section IV.

CONCLUSION

For the reasons set forth above, the motion of BDO to dismiss the TAC should be denied.

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