UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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In re

J. EZRA MERKIN AND BDO SEIDMAN
SECURITIES LITIGATION

No. 08 Civ. 10922 (DAB)

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MEMORANDUM OF DEFENDANT BDO SEIDMAN, LLP IN SUPPORT OF MOTION TO DISMISS

New York Law School v. Ascot Partners, L.P. et al Doc. 49

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STATEMENT OF FACTS

Defendant BDO Seidman, LLP ("Seidman") moves to dismiss. The facts that follow come from the second amended complaint ("Complaint"), a copy of which is annexed for the Court's convenience to the moving declaration of Ira G. Greenberg as exhibit A. Seidman does not admit that the Complaint's factual allegations are correct. It merely assumes their validity as required on a motion of this kind.

Insofar as is relevant, the representative plaintiffs, New York Law School and Scott Berrie, invested in limited partnership interests in domestic hedge funds, respectively, Ascot Partners, L.P. in 2006, and Gabriel Capital, L.P. in 2007 (¶¶ 3, 18-19, 33-34 & Berrie Certification).[1] They purport to sue on behalf of a class of investors from December 11, 2003, to December 11, 2008, for claims under the Securities Exchange Act of 1934, and for all investors who held such interests at December 11, 2008, for pendent state law claims (¶ 36).

The Complaint alleges that defendants Ezra Merkin and his management company, Gabriel Capital Corporation, ran the funds (¶¶ 2, 4, 21). It also sets forth in detail any number of knowing misrepresentations that they made, principally about how the funds were to be managed, in what they were to invest, and what Merkin's role was to be (¶¶ 48-76, 81-92, 105-15) -- most significantly, that Merkin would personally control the investments, when he in fact planned to and did abdicate such control to Bernard Madoff[2] (e.g., ¶¶ 10, 12-13).

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[1] Parenthetical paragraph cites are to the Complaint. Paragraph 19 refers to but does not attach the certification. A copy, which the Court may judicially notice, is attached to the first amended complaint.

[2] This memorandum uses the term "Madoff" in most instances as a shorthand for his business entity, Bernard L. Madoff Investment Securities, LLC.

Madoff was a well-known industry figure who had pioneered electronic trading and was a major market maker, and he appeared to have had a nearly unbroken history of investing success (¶ 46). In fact, however, Madoff had been running a massive Ponzi scheme since the early 1990s (¶¶ 1, 5-6, 43) and had not actually invested any of the money entrusted to him since about that time (¶ 43; see ¶ 42). As is well known, the scheme unraveled in late 2008 (¶¶ 5, 38-45).

The United States Securities and Exchange Commission and the Financial Industry Regulatory Authority regulated Madoff's business (¶ 46). A whistleblower had repeatedly reported to the SEC over the years that Madoff was a fraud (¶¶ 127, 133-34). Even though that agency conducted at least three investigations of Madoff's operations, it did not uncover his fraudulent scheme (¶ 122). It took no action against him.

A limited number of articles in the financial press had questioned how Madoff could be so successful (¶¶ 121-22, 125-26), and some in the financial community had decided for themselves or had counseled their clients not to invest with Madoff based on their suspicion that his results were too good to be true (¶¶ 124, 130-33, 141-42). However, "'[t]here were no smoking guns'" (¶ 143), and the very size of the losses – as much as $50 billion (¶ 6) – meant that Madoff had fooled many sophisticated investors and others with expertise in the industry.

Seidman did not audit Madoff or of any of his entities (see ¶ 171), nor did it make or monitor the propriety of the funds' investment decisions. Its only role was to serve as auditor of the Ascot and Gabriel funds (¶ 23). There is nothing to suggest that Seidman knew, or that it had an obligation as an auditor to have known, of the

whistleblower's statements to the SEC, the articles in the financial press, or the decisions of others not to invest with Madoff. The Complaint (¶¶ 119-20) cites a number of supposed "red flags" that "should have been known to investment professionals" such as Merkin; but it does not plead that Seidman, acting as the funds' auditors, should have known of those "red flags."[3]

Each fund was to distribute the financials that Seidman had audited to its investors within specified periods after year-end (¶ 169). Seidman knew that the funds' investors would receive and rely on them (¶ 23).

In contrast to the well-organized factual allegations against Merkin and his management company, the Complaint makes a hodgepodge of assertions against Seidman (¶¶ 171-82). Seidman is alleged to have "failed to perform its work as auditors . . . in a manner consistent with the standards of the auditing profession and as required by Generally Accepted Auditing Standards ('GAAS')" (¶ 166). These auditing standards are "codified in Statements on Auditing Standards ('AU')" (¶ 173). Essentially, the Complaint says that by the terms of the applicable auditing standards (¶¶ 173-74), a number of facts to which it points (¶ 171) should have caused Seidman to conduct further audit work. In addition, it alleges that Seidman should have learned more about Merkin's and Madoff's (the individuals') internal controls (¶ 176) and should have assessed Madoff's own accounting (¶ 177). As a result, Seidman's opinions (¶¶ 169-70) that the funds' financial statements were fairly presented under Generally Accepted Accounting Principles, or GAAP, turned out to be erroneous.

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[3] The Complaint has some general allegations about what "defendants" did or knew (e.g., ¶ 145), but it is clear in context that those allegations relate only to defendants Merkin and Gabriel Capital.

Based on these assertions, the amended complaint alleges claims against Seidman for violation of section 10(b) of the Exchange Act and of rule 10b-5 under it (count III), aiding and abetting a breach of fiduciary duty (count V), unjust enrichment (count VII), common law fraud (count VIII), negligent misrepresentation (count IX), and professional negligence (count X).

ARGUMENT

I. THE EXCHANGE ACT CLAIM MUST BE DISMISSED

There are three elements of an Exchange Act claim not adequately pleaded in the Complaint: purchase and sale; scienter; and causation.

A. Purchase and Sale

Standing to bring a private action under section 10 and rule 10b-5 is limited to "actual purchasers and sellers of securities." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730, 737-38, 750, 754-55 (1975); Caiola v. Citibank, N.A., 295 F.3d 312, 322 (2d Cir. 2002). Holders of securities, including those who claim that they were fraudulently induced not to sell, lack standing. Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71, 79-81 (2006); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 737-38, 754-55; Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir. 1977); Gurary v. Winehouse, 190 F.3d 37, 46 n.9 (2d Cir. 1999).

Plaintiffs do not allege that they received and relied on Seidman's audit reports in deciding to invest in the funds. To the contrary, the Complaint alleges only that Seidman "knew that the audited financial statements would be provided to and relied on by . . . limited partners" – those who had already invested (¶ 23; see ¶ 167: offering memoranda say audited financials to be provided to limited partners; ¶¶ 169-70:

audit opinions addressed to partners). The rule 10b-5 count echoes these averments (¶¶ 207, 210). Consequently, this claim falls.

B. Scienter

1. What Scienter Is. Congress has required that a complaint "state with particularity facts giving rise to a strong inference" that a defendant have "acted with the required state of mind," 15 U.S.C. § 78u-4(b)(2), as a prerequisite to maintaining such a claim. To the same effect, see, e.g., ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99 (2d Cir. 2007); Acito v. IMCERA Group, Inc., 47 F.3d 47, 52 (2d Cir. 1995); cf. Stevelman v. Alias Research Inc., 174 F.3d 79, 84 (2d Cir. 1999) (same requirement derived from Fed. R. Civ. P. 9(b)'s "why" element). Scienter – a guilty state of mind – is and long has been an element of the cause of action. E.g., Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001); Chill v. General Elec. Co., 101 F.3d 263, 266 (2d Cir. 1996); Acito v. IMCERA Group, Inc., 47 F.3d at 52.

"The requisite state of mind . . . that the plaintiff must allege is '"an intent to deceive, manipulate or defraud."'" Kalnit v. Eichler, 264 F.3d at 138 (citations omitted). Thus, the Court must be able to infer from the pleaded facts that a defendant intended to participate in a fraud. Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000); Novak v. Kasaks, 216 F.3d 300, 313 (2d Cir. 2000) ("a state of mind 'approximating actual intent, and not merely a heightened form of negligence'"); see Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982) ("approximate an actual intent to aid in the fraud being perpetrated") (predating Reform Act).

The required intent is thus different in kind, and not just in degree, from negligence. Neither "recklessness" nor "gross negligence" is a "state of mind," in the

words of the statute; rather, it is at most evidence of a state of mind. Thus, neither the auditor's alleged violations of professional standards, such as GAAS, e.g., Stevelman v. Alias Research, Inc., 174 F.3d at 84; Chill v. General Elec. Co., 101 F.3d at 270, nor allegedly inadequate attention to detail or insufficient skepticism suffices. Chill v. General Elec. Co., 101 F.3d at 270; Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129 (2d Cir. 1994). Rather, the defendant have must have acted in a way such that either it actually knew of the danger or the danger was so obvious that the defendant had to have known of it. Kalnit v. Eichler, 264 F.3d 142; In re Carter-Wallace, Inc. Secs. Litigation, 220 F.3d 36, 39 (2d Cir. 2000); Rothman v. Gregor, 220 F.3d at 93.

2. How Scienter Is Tested. The Supreme Court emphasized the importance of the scienter element and explained its application in Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007), when it held that a district court "must engage in a comparative evaluation" by considering "competing inferences rationally drawn from the facts alleged." "To qualify as 'strong'" within the meaning of the statute, "an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Accord, ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d at 99.

In the absence of concrete benefits to be realized by the defendant from participating in the fraud,[4] the Court of Appeals has held that a plaintiff must plead facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. E.g., Kalnit v. Eichler, 264 F.3d at 142 ("Where motive is not apparent, . . . the strength

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[4] The so-called "motive and opportunity" method of proving scienter, e.g., Rothman v. Gregor, 220 F.3d 81, 93 (2d Cir. 2000), is unavailable to plaintiffs as against Seidman, as the receipt of compensation for professional services does not constitute the requisite motive. E.g., Acito v. IMCERA Group, Inc., 47 F.3d at 54.

of the circumstantial allegations must be correspondingly greater"). Moreover, "fraud by hindsight" is not actionable. E.g., Novak v. Kasaks, 216 F.3d at 309; Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978). Rather, the Court takes a prospective view – how the facts looked before the fraud became apparent.

> Hindsight is always 20/20. Once a result is known, along with all the intervening events which caused it, it is all but humanly impossible to put that knowledge out of mind when determining whether those occurrences could reasonably have been anticipated. But the present inquiry demands that we strive as scrupulously as possible to view the situation as it existed at the time of [the services], with the knowledge [the auditor] then had, and without the knowledge we now have of what actually happened thereafter.

AUSA Life Ins. Co. v. Ernst & Young, 119 F. Supp. 2d 394, 402 (S.D.N.Y. 2000). Nor may the Court evade this stricture by purporting to infer fraudulent intent solely from the magnitude of a fraud, especially when the person committing the fraud (Madoff) has undertaken extensive efforts to hide it. In re Livent, Inc. Secs. Litigation, 78 F. Supp. 2d 194, 217 (S.D.N.Y. 1999) (and cases cited); see Decker v. Massey-Ferguson, Ltd., 681 F.2d at 120.

Our courts recognize that they must apply these standards rigorously in actions against auditors. See, e.g., In re Tremont Secs. Law, State Law & Ins. Law Litigation, No. 08 Civ. 11117 (TPG), slip op. at 12 (S.D.N.Y. Mar. 30, 2010) (hereinafter, "Tremont") ("The standard for pleading auditor scienter is demanding"); AUSA Life Ins. Co. v. Ernst & Young, 119 F. Supp. 2d at 405 ("public policy requires that auditors be held liable for only those losses which foreseeably result from their deliberate deception or reckless insouciance"). Courts should be particularly chary of drawing inferences of scienter when an auditor's not discovering a fraud puts it on par with the regulatory body

with cognizance over the entity that committed the fraud. See In re Bayou Hedge Fund Litigation, 534 F. Supp. 2d 405, 418 (S.D.N.Y. 2007), aff'd sub nom. South Cherry St., LLC v. Hennessee Group LLC, 573 F.3d 98 (2d Cir. 2009).

Liberal use of the colorful term "red flags" does not substitute for testing the pleaded facts against the Tellabs standard. "Merely labeling allegations as red flags . . . is insufficient to make those allegations relevant to a defendant's scienter." In re Marsh & McLennan Cos., Inc. Secs. Litigation, 501 F. Supp. 2d 452, 487 (S.D.N.Y. 2006). More particularly, proffered "red flags" must put the auditors on clear notice of the fraud, such that a failure to do more tends to prove their implication in that wrongdoing. See, e.g., In re AOL Time Warner, Inc. Secs. & "ERISA" Litigation, 381 F. Supp. 2d 192, 240 & n.51 (S.D.N.Y. 2004) (and cases cited); In re Oxford Health Plans, Inc. Secs. Litigation, 51 F. Supp. 2d 290, 294 (S.D.N.Y. 1999). "Where a transaction derives its suspiciousness from specific details associated with the audited company's business, the plaintiff must plead facts suggesting the accountant's awareness of those details." Reiger v. Price Waterhouse Coopers, 117 F. Supp. 2d 1003, 1009 (S.D. Cal. 2000), aff'd, 288 F.3d 385 (9th Cir. 2002); In re Livent Inc. Secs. Litigation, 148 F. Supp. 2d 331, 369 (S.D.N.Y. 2001). "[M]erely alleging that the auditor had access to the information by which it could have discovered the fraud is not sufficient." Tremont, slip op. at 12.

3. Application to this Complaint.

One searches this complaint in vain for any basis on which to infer that Seidman was part of Madoff's fraud or any alleged fraud by Merkin. The question on the scienter issue here is whether, ex ante, Seidman knew or was willfully blind in not

knowing that the funds' financial statements were wrong because the assets on their balance sheets that were supposed to have been held by Madoff did not actually exist. The Complaint does not come close to pleading facts that give rise to the required strong inference of intent on that issue. Indeed, it does not plead any facts that remotely suggest that Seidman was in on the fraud. It even alleges in the rule 10b-5 count (¶ 208) that Seidman "knew or should have known" that the financial statements were erroneous – the latter being language of negligence, not of <u>scienter</u>.[5]

Moreover, it makes Seidman's point in noting (¶ 144) that "forensic accountants" use tests to detect potential securities fraud in situations such as this. But as its audit opinion (¶ 169) made clear, Seidman was not acting as a "forensic accountant," essentially an accounting-savvy fraud investigator. The procedures that forensic accountants use far exceed those that GAAS requires for a financial statement audit. Even beyond that, it was not even acting as the financial statement auditor for Madoff, but rather for the two Merkin hedge funds, Ascot and Gabriel, so it was not even auditing the entity engaged in financial fraud. <u>See</u> <u>Tremont</u>, slip op. at 13 ("But most cricitcally, the Auditors were never engaged to audit Madoff's business or to issue an opinion on the financial statements of [Madoff]").

Seidman had plenty of company in missing Madoff's Ponzi scheme. The SEC and FINRA did not, even though they had direct cognizance over Madoff and investigatory powers that a financial statement auditor lacks. Likewise, any number of financial institutions, hedge funds, charitable organizations, and sophisticated investors,

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[5] Indeed, the Complaint does not even successfully plead lack of due care, as is more fully shown in Point VI below, to which the Court is respectfully referred. That failure establishes Seidman's point here <u>a fortiori</u>.

all of which had a direct financial incentive not to give their money to one engaged in a Ponzi scheme, did not. The auditors of many other funds and institutions around the world did not find Madoff's fraud either. Yet no one would conclude that all of them were in on Madoff's scheme. As Judge Griesa held recently in Tremont, slip op. at 13, "[T]he more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme and eluding the SEC and other financial professionals." See also In re Doral Fin. Corp. Secs. Litigation, 563 F. Supp. 2d 461, 465 (S.D.N.Y. 2008).

Scienter is thus lacking as well.

C. Causation

Third, one alleging federal securities fraud must plead causation. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 346 (2005); In re Omnicom Group, Inc. Secs. Litigation, 2010 WL 774311, at *7 (2d Cir.); ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d at 106; Lentell v. Merrill Lynch & Co., 396 F.3d 168, 172 (2d Cir. 2005).

This Complaint fails to plead causation for holder claims, putting aside that such claims are not cognizable under rule 10b-5. If the audited financials had revealed that Madoff was a sham who was running a Ponzi scheme, every investor, all of whom would have received the financials at about the same time, would have known; and obviously, every investor, not just plaintiffs, would have made a claim for the return of his or her investment more or less simultaneously. Thus, the Complaint does not plead how plaintiffs would have recovered their investment if Seidman had revealed the errors in the financial statements after plaintiffs had invested. Put another way, Seidman's

alleged "misrepresentations" on which plaintiffs supposedly relied did not cause them any injury.

II. ALL STATE LAW CLAIMS MUST BE DISMISSED.

All state law claims must be dismissed by virtue of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA requires dismissal of any action involving a covered class action brought under state law alleging misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security. 15 U.S.C. § 78bb(f)(1)(A). Each criterion is satisfied here.

This is a covered class action because plaintiffs seek to recover damages on behalf of more than fifty persons, and questions of law and fact common to the members of the class are alleged to predominate over questions affecting any individual class member. (¶ 37). See 15 U.S.C. § 78bb(f)(5)(B) (defining covered class action).

The Complaint alleges five counts against Seidman brought under New York common law.

Plaintiffs allege that they held their limited partnership interests as the result of Seidman's misrepresentations or omissions (¶¶ 179-81). The state law causes of action need not be for fraud to satisfy SLUSA. See Instituto de Prevision Militar v. Merrill Lynch, 546 F.3d 1340, 1350 (11th Cir. 2008) (negligence, breach of fiduciary duty, and fraud); Kingdom 5-KR-41, Ltd. v. Star Cruises PLC, 2004 WL 444554, at *3, *5 (S.D.N.Y.) (negligence, unjust enrichment, and breach of contract).

The alleged misrepresentations or omissions were "in connection with" the purchase or sale of a covered security. That phrase is more inclusive than the purchase and sale requirement under rule 10b-5 in that it includes claims by securities holders, such as plaintiffs here. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547

U.S. 71, 84-85 (2006); see SEC v. Zandford, 535 U.S. 813, 820, 822 (2002); Instituto de Prevision Militar v. Merrill Lynch, 546 F.3d at 1349. Likewise, claims based on the failure to purchase covered securities fall within SLUSA's preclusive ambit. E.g., Barron v. Igolnikov, 2010 WL 882890, at *4-5 (S.D.N.Y.).

Finally, the alleged misrepresentations and omissions were in connection with the purchase and sale of a "covered security." As alleged in the Complaint, plaintiffs purchased limited partnership interests based in part on the representations made in the various offering memoranda that the funds would invest in "a portfolio of large-cap U.S. equities drawn from the S&P 100" (¶ 62); "a diverse portfolio of securities" and "U.S. and non-U.S. marketable and non-marketable, equity and debt securities" (¶ 89); and "marketable securities" including "common stock" (¶ 99).

The Supreme Court in Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. at 86, directed that SLUSA be given "a broad construction," in order to prevent the application of different standards to securities claims brought in a representative capacity on identical facts. It held that the "in connection with" language evinced Congress' intent that SLUSA have a broad preemptive effect. Id. at 85-86. "It is enough that the fraud alleged 'coincide' with a securities transaction – whether by plaintiff or by someone else. The requisite showing . . . is 'deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller.'" Id. at 85 (citations omitted).

Thus, limited partnership interests in funds that invested in the Ascot Fund – one of the funds at issue in this action – were covered securities within the meaning of

SLUSA because Madoff claimed that he would purchase and sell covered securities. Barron v. Igolnikov, 2010 WL 882890, at *4-5.

> Madoff told investors that he would purchase and sell securities in the S&P 100 Index but never consummated any trades. Central to his fraud, Madoff used prices from the public markets on the trade documentation he sent to customers. In light of the Supreme Court's command that SLUSA be construed expansively, it is enough that this fraudulent scheme was in connection with the trading in the nationally listed securities in which Madoff claimed to be engaged. It is not essential that Madoff actually performed any trades or acquired any securities. And while plaintiff and members of the putative class purchased limited partnership interests in the [funds] – which in turn invested in covered securities [through Ascot Fund] – rather than covered securities directly from Madoff, SLUSA preemption is justified because the securities transaction need not have been performed by plaintiff. Rather, it is only necessary to demonstrate deception in connection with the purchase or sale of a covered security, not the deception of plaintiff herself.

Id. at *5 (citing Dabit and Zandford); accord, Levinson v. PSCC Servs., Inc., 2009 WL 5184363, at *8-12 (D. Conn.) (fund that invested in Madoff funds is covered security because alleged misrepresentations coincided with Madoff's purported purchase and sale of securities with plaintiffs' money); Backus v. Connecticut Community Bank, N.A., 2009 WL 5184360, at *6-9 (D. Conn.) (retirement funds pooled in collective account and invested in Madoff funds are covered securities).[6]

As such, the state law claims are barred by SLUSA.

* * *

[6] Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Secs., LLC, 2010 WL 546964 (S.D.N.Y.), reached a contrary conclusion by reading Merrill Lynch narrowly. In so doing, the Pension Committee court apparently did not appreciate the Supreme Court's directive in Merrill Lynch that the fraud need only "coincide" with a transaction in covered securities, 547 U.S. at 85, in order to achieve Congress' objectives.

But even if SLUSA did not bar the state law claims, the outcome would be the same. Each of them fails under separate analysis as well.

III. THE COMMON LAW FRAUD CLAIM MUST BE DISMISSED.

A. Scienter

The elements of fraud are essentially the same as those under rule 10b-5. E.g., Tremont, slip op. at 14; Fezzani v. Bear, Stearns & Co., 592 F. Supp. 2d 410, 423 (S.D.N.Y. 2008). As under rule 10b-5, the elements of a common law fraud claim include scienter. E.g., Ross v. Louise Wise Servs., Inc., 8 N.Y.3d 478, 488, 836 N.Y.S.2d 509, 515, 868 N.E.2d 189, 195 (2007); Lama Holding Co. v. Smith Barney Inc., 88 N.Y.2d 413, 421, 646 N.Y.S.2d 76, 80, 668 N.E.2d 1370, 1373 (1996). Plaintiffs making this claim must also plead facts that give rise to "a strong inference of fraudulent intent." Baraliu v. Vinya Capital, L.P., 2009 WL 959578, at *8 (S.D.N.Y.); Edison Fund v. Cogent Inv. Strategies Fund, Ltd., 551 F. Supp. 2d 210, 232 (S.D.N.Y. 2008).

The discussion of scienter above applies here equally. As with federal securities fraud, a plaintiff's use of the labels "recklessness" or "gross negligence" does not transmute negligence claims into something more sinister, e.g., Giant Group, Ltd. v. Arthur Andersen LLP, 2 A.D.3d 189, 190, 770 N.Y.S.2d 291, 292 (1st Dep't 2003) ("'[N]egligence claims cannot be deemed fraud solely because of the nomenclature used'"); and GAAS or GAAP violations "do[] not make out fraud," LaSalle Nat'l Bank v. Ernst & Young L.L.P., 285 A.D.2d 101, 109, 729 N.Y.S.2d 671, 677 (1st Dep't 2001). Rather, as with the federal securities claim, "'an opinion, especially an opinion by an expert, may be found to be fraudulent [only] if the grounds supporting it are so flimsy as

to lead to the conclusion that there was no genuine belief back of it.'" Ambassador Factors v. Kandel & Co., 215 A.D.2d 305, 308, 626 N.Y.S.2d 803, 806 (1st Dep't 1995) (citation omitted).

Consistent with the foregoing, auditor cases that have sustained fraud complaints against a motion to dismiss have involved situations in which the auditor either knew that the audit opinion was erroneous or, at a minimum, had actual knowledge of facts that made it obvious that the audit opinion was wrong. Thus, for example, in DaPuzzo v. Reznick Fedder & Silverman, 14 A.D.3d 302, 303, 788 N.Y.S.2d 69, 70-71 (1st Dep't 2005), the complaint alleged that the auditor had not only "ignored and failed to report the client's lack of internal controls [and] blindly accepted information provided by the client's chief financial officer without independent verification," but it also "gave in to the CFO's demands to fix the financial reports to represent a more favorable financial position in order not to jeopardize its fee." As already seen, this Complaint does not allege facts from which one may plausibly infer that Seidman had the intent to engage in fraud or that it had knowledge of another's fraud that it intentionally ignored – the first reason why the fraud claim (count VIII) must be dismissed.

B. Causation

Also as with the rule 10b-5 claim, another element of a fraud claim is causation. Ross v. Louise Wise Servs., Inc., 8 N.Y.3d at 488, 836 N.Y.S.2d at 515, 868 N.E.2d at 195-96; Greater N.Y. Mut. Ins. Co. v. White Knight Restoration, Ltd., 7 A.D.3d 292, 293, 776 N.Y.S.2d 257, 258 (1st Dep't 2004). This element is absent for the reasons set forth in Point I.B. supra.

IV. THE AIDING AND ABETTING BREACH OF FIDUCIARY DUTY CLAIM MUST BE DISMISSED.

The aiding and abetting breach of fiduciary duty claim must be dismissed because the complaint does not plead its elements. "A claim for aiding and abetting a breach of fiduciary duty requires: (1) a breach by a fiduciary of obligations to another, (2) that the defendant knowingly induced or participated in the breach, and (3) that plaintiff suffered damage as a result of the breach." Kaufman v. Cohen, 307 A.D.2d 113, 125, 760 N.Y.S.2d 157, 169 (1st Dep't 2003). In connection with the second element, "there must be an allegation that such defendant had actual knowledge of the breach of duty"; "[c]onstructive knowledge of the breach of fiduciary duty by another is legally insufficient." Id. Moreover, the defendant must have provided "'substantial assistance'" to the primary violator, which only occurs when it "affirmatively assists, helps conceal or fails to act when required to do so." Id. at 126, 760 N.Y.S.2d at 170.

This Complaint is devoid of any allegations that Seidman had actual knowledge of any breach of fiduciary duty by the Merkin defendants. To the contrary, paragraph 222 alleges that Seidman may have "recklessly ignored information that indicated or should have indicated" that Merkin and Gabriel Capital "did not have [a] genuine belief [in] or a reasonable basis" for their financial statements. Likewise, the Complaint (¶ 223) does not allege that Seidman did any more than incorrectly "issuing clean audit opinions" when it should not have. There is nothing to support the assertion that it knowingly induced or participated in Merkin's or Gabriel Capital's breach.

Finally, for the reasons set out in Point I.C above, plaintiffs did not suffer damages from the allegedly actionable conduct – the issuance of audited financial statements to holders of limited partnership interests.

V. THE UNJUST ENRICHMENT CLAIM MUST BE DISMISSED.

The unjust enrichment claim, seeking the return of auditing fees, must be dismissed on two grounds.

First, plaintiffs are not proper parties to bring the claim, as they did not pay the fees and thus were not damaged directly. Even if a limited partner might have brought a derivative action on behalf of the limited partnership, Del. Code tit. 6, §§ 17-1001 to -04; see Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965), the requirements of Fed. R. Civ. P. 23.1 must still be met. Here, plaintiffs have done nothing even to attempt to meet those requirements.

The problem is not just a pleading one, however. The claim should be dismissed, second, because it in effect seeks a duplicate recovery. Underlying all of the claims against Seidman is the premise that its audits at the least did not meet professional standards. If plaintiffs were to prevail on their other claims and to receive a damages award, they would be made whole. On the other hand, if class plaintiffs do not prevail on their other claims, they cannot prevail on this one. Either way this claim does not survive.

VI. THE NEGLIGENCE-BASED CLAIMS MUST BE DISMISSED.

Though alleged in two separate counts denominated negligent misrepresentation and professional negligence, there is only one. See Mecca v. Shang, 258 A.D.2d 569, 570, 685 N.Y.S.2d 458, 460 (2d Dep't 1999) ("[T]he court should have also dismissed Dr. Mecca's negligent misrepresentation and gross negligence causes of action, since these claims . . . arise from the same facts as his . . . malpractice claim and are duplicative of that cause of action"); In re Wedtech Corp., 81 B.R. 240, 241

(S.D.N.Y. 1987) (Sand, J.) (treating same claim against accountant, essentially charging malpractice under different legal rubrics, as one).[7]

A. Causation

Proximate cause is an element of the claim. E.g., Sheehan v. City of New York, 40 N.Y.2d 496, 501-02, 387 N.Y.S.2d 92, 95, 354 N.E.2d 832, 834 (1976). For the reasons set forth in section I.C supra, that element is lacking here.

B. No Breach of Duty

Finally, the Complaint attempts to make out a claim for negligent misrepresentation by purporting to list a number of "red flags," make general references to certain auditing standards, and assert that Seidman should have done something more – although it is not clear what or how doing that "something" would have mattered. The Complaint fails in this effort also.

1. The "Red Flags"

As noted, Seidman was an auditor, not an investment advisor, and it was auditing two hedge funds, not Madoff. As a result, it did not have the unfettered access that it would if Madoff were the audit client. In addition, the assets in question at year-end – the time as of which the financial statements spoke -- were United States Treasury bills (¶ 128). Their valuation, if they had existed, was not subject to any doubt.

[7] Plaintiffs lack standing to the extent that they purport to be suing other than as holders. SIPC v. BDO Seidman, LLP, 95 N.Y.2d 702, 711, 723 N.Y.S.2d 750, 756, 746 N.E.2d 1042, 1048 (2001) (must know that "the particular plaintiffs" bringing action relied on representations when preparing audit) (emphasis in original); SIPC v. BDO Seidman, LLP, 222 F.3d 63, 75 (2d Cir. 2000) ("must show some form of direct contact between the accountant and the plaintiff, such as a face-to-face conversation, the sharing of documents, or other 'substantive communications' between the parties"). See generally Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 551, 493 N.Y.S.2d 435, 443, 483 N.E.2d 110, 118 (1985) (three-part test applicable in New York).

Even during the year, the assets were purportedly held as S&P 100 securities (¶ 47) – again, easy to value and, if they existed, not speculative investments. When those facts are understood, most of the supposed "red flags" (¶ 176) change color, at least as to Seidman.

The Complaint pleads the funds' delegation of investment decisions to Madoff; but whether, because of that delegation, Madoff could have made bad investment decisions with adverse consequences for the funds is not an auditing issue. The auditing issue is whether the delegation to Madoff raised the likelihood of errors that materially affected the financial statements. The Complaint does not plead how it did, because it did not.

Similarly, the Complaint pleads a divergence from the original investment plan as set forth in the offering memoranda; but, again, the issue is not whether the funds adhered to that investment plan. There is no claim that Seidman wrote or otherwise adopted the offering memoranda as its own. Again, the question is, assuming such a divergence, whether it affected the likelihood of error in the financial statements. Again, the Complaint does not plead how it did, because it did not.

The Complaint also pleads that Madoff's returns were unusual in being consistently positive and that there were discrepancies between certain published information about Madoff and the amounts that he managed for these funds. But the Complaint does not allege how Seidman was supposed to have known these "facts," let alone to have made something of them. The auditing literature does not require an auditor to know everything that one who is an expert in complex securities trading

strategies might, see AU 110.04 (Greenberg Decl. exh. B),[8] and the Complaint does not plead that the supposed anomalies were brought to its attention. See, e.g., Tremont, slip op. at 12 ("merely alleging that the auditor had access to information by which it could have discovered the fraud is not sufficient").

Finally, Madoff's use of a small accounting firm is unimportant, because there was no need for Seidman – or the funds – to know whether Madoff's financial statements were correct or incorrect. (The investments of entities like the funds here would not appear on Madoff's balance sheet.) Seidman only had to know that the Treasury bills were really there, and that question is unaffected by the size of custodian's accounting firm. Indeed, the Complaint does not allege that Seidman relied on any statement from Madoff's auditor as support for the existence of these assets. If it had, the Madoff auditor's misstatement would not have been the product of too few auditors or too little expertise to audit Madoff; it would have been the product of the fact that its lead auditor was in cahoots with Madoff (see ¶ 44) – which the Complaint does not allege that Seidman knew.

On the other hand, the fact that Madoff was a broker-dealer registered with and extensively regulated by the SEC and FINRA and the absence of any action by either of them would have provided Seidman comfort. Though Seidman would not necessarily have known it, the fact that the SEC, armed with the investigatory power of the federal government, undertook multiple investigations at Madoff and did nothing (¶ 122) would have been significant. Further, the fact that the SEC consistently accepted

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[8] The Complaint's citation of auditing standards results in their being deemed incorporated by reference and subject to the Court's consideration on a motion to dismiss. Roth v. Jennings, 489 F.3d 499, 509 (2d Cir. 2007).

the small accounting firm's rule 17a-5 filings concerning the adequacy of Madoff's internal controls further negated negligence in Seidman's part in not following up on that firm. See Rule 17a-5(f)(2), 17 C.F.R. § 240.17a-5(f)(2) (auditor of broker-dealer to be identified and filed with SEC).

2. The Auditing Standards

The Complaint also cites a number of auditing standards as supposedly supportive of its negligence claim. They do nothing of the kind. See note 8 supra (standards deemed incorporated by reference into Complaint).

The auditing standards make clear that the mere fact that financial statements turn out to be wrong does not mean that the audit opinion was wrong. An audit opinon says only that, based on appropriate audit tests, the auditor has reached the opinion that the financial statements fairly present in material respects the information that they contain. Similarly, the fact that financial statements turn out to be wrong do not mean that the audit failed to comply with GAAS. "Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement." AU 230.12 (Greenberg Decl. exh. C); accord, AU 311.09 (eighth bullet point) (id. exh. D); AU 326.12 (id. exh. E). That proposition is of even more force when, as in this case, the entities being audited – and, hence, the ones to which the auditor has full access – are not the ones at which the fraud took place (Madoff). The Complaint alleges no financial shenanigans of any kind at the entities under audit, the Ascot and Gabriel funds.

For the most part the standards on which plaintiffs rely simply say that the auditor must use due care in auditing with appropriately trained and supervised

personnel. The audit evidence standard confirms that "[a]uditors are not expected to examine all information that may exist," AU 326.02 (Greenberg Decl. exh. F). The fraud auditing standard, AU 316.68, does list conditions that may change the auditor's assessment of the audit risks, but none of them is remotely applicable to this case.

AU 332, a copy of which is exhibit G to the Greenberg declaration, at least does talk about investments in securities, but the Complaint's discussion of it is both all over the place and wrong on the face of that standard.

AU 332.21 specifically allows the auditor to verify "existence or occurrence assertions" via "confirmation with the holder of the security" (second bullet point) and "with the broker-dealer or counterparty" (third bullet point). The Complaint effectively pleads that Seidman did so via confirmation with Madoff (¶¶ 175, 177, 179). To the extent that the Complaint suggests that Seidman should have obtained information from "independent" third parties, it ignores the fact that Madoff was precisely that, and a federally-regulated, registered broker-dealer, no different in this regard from Goldman Sachs or Merrill Lynch, for example, to boot.

The Complaint fails to say why Seidman was obliged to seek confirmation from other third parties, nor does it specify what other third parties might have confirmed the existence of the Treasury bills. The United States Government was the counter-party to the Treasury bills; it does not provide confirmations to auditors; and, in any event, only Madoff, and not Seidman's audit clients, the Merkin funds, had standing to seek a confirmation even if the Government had been willing to provide one. Accordingly, the notion that Seidman could have verified their existence by obtaining a confirmation from the counterparty – the Treasury Department – lacks plausibility, as

Ashcroft v. Iqbal, 129 S.Ct. 1937, 1949 (2009), requires.

The remainder of the Complaint's description of AU 332 relates to provisions concerning assessing control risk in order to plan the audit. They say that what the auditor does in this regard is a matter of professional judgment. AU 332.11. A fund auditor was therefore not required to look into controls at Madoff. Id. It would thus be erroneous to say that Seidman violated AU 332's strictures, even assuming that they might otherwise be read to apply to Madoff.

But they do not by AU 332's terms, because that standard relates only to a "service organization whose services are part of the entity's information system." AU 332.11. Madoff did not meet those criteria because it did not have access to or enter transactions in the funds' financial books and records, in contradisctinction to an entity that would be part of the "information system," such as ADP when payroll functions are delegated to it.

AU 332.13 reinforces this conclusion by creating a specific exemption for one in Madoff's position, even if it had met AU 332's other criteria:

> Examples of a service organization's services that would not be part of an entity's information system are the following:
> - The execution by a securities broker of trades that are initiated by either the entity or its investment adviser
> - The holding of an entity's securities

Here, Madoff was acting as a broker with the discretion to trade Ascot's and Gabriel's accounts (¶ 7), and the very services at issue are the broker's execution of trades (first bullet point) and holding of the securities that belonged to the funds (second bullet point). By its terms, therefore, AU 332 is not applicable.

Judge Griesa hit the nail on the head:

> [M]ost critically, the Auditors were never engaged to audit Madoff's businesses or to issue an opinion on the financial statements of [Madoff Securities]. The Auditors' only role is that they audited the financial statements of the [funds]. The notion that a firm hired to audit the financial statements of one client [the funds] must conduct audit procedures on a third party that is not an audit client [Madoff Securities] on whose financial statements the audit firm expresses no opinion has no basis. To impose liability on the Auditors would expand their limited, circumscribed duty impermissibly.

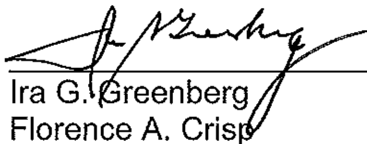
Tremont, slip op. at 13-14. See also In re Parmalat Secs. Litigation, 501 F. Supp. 2d 560, 591 (S.D.N.Y. 2007) (dismissal of claims against auditor where it audited subsidiary and fraud had occurred at parent in absence of proof of auditor's knowledge of fraud).

CONCLUSION

Plaintiffs may not maintain this action against Seidman. It should be dismissed.

Dated: New York, NY
April 12, 2010

Respectfully submitted,



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