New York Law School v. Ascot Partners, L.P. et al Doc. 74

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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In re : No. 08 Civ. 10922 (DAB)

J. EZRA MERKIN AND BDO SEIDMAN SECURITIES LITIGATION :

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CROSCILL INC., et al., :

Plaintiffs, : No. 09 Civ. 6031 (DAB)

-against- :

GABRIEL CAPITAL, L.P. et al., :

Defendants.

--------------------------------------- X

MORRIS FUCHS HOLDINGS, LLC :

Plaintiff, : No. 09 Civ. 6483 (DAB)

-against- :

GABRIEL CAPITAL, L.P. et al., :

Defendants.

--------------------------------------- X

MEMORANDUM OF LAW
IN SUPPORT OF DEFENDANTS J. EZRA MERKIN AND
GABRIEL CAPITAL CORPORATION'S MOTION TO DISMISS

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Preliminary Statement

Defendants J. Ezra Merkin ("Merkin") and Gabriel Capital Corporation ("GCC," and collectively "Defendants") respectfully submit this memorandum of law in support of their motion to dismiss, pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure, the Third Consolidated Amended Class Action Complaint (the "TAC") of Plaintiffs New York Law School ("NYLS"), Scott Berrie ("Berrie"), Jacob E. Finkelstein CGM IRA Rollover Custodian ("Finkelstein"), and Nephrology Associates PC Pension Plan ("Nephrology," and collectively "Plaintiffs"), as well as the separate Complaints of Croscill, Inc., Florence Kahn Weinberg Intervivos Trust, Douglas J. Kahn 2008 Family Trust, and David Kahn 2008 Family Trust (collectively, "Croscill"), and Morris Fuchs Holdings, LLC ("Fuchs").

Plaintiffs purport to bring this action on behalf of investors in three hedge funds -- Ascot Partners, L.P. ("Ascot"), Gabriel Partners, L.P. ("Gabriel"), and Ariel Fund, Ltd. ("Ariel," and collectively the "Funds"). Croscill and Fuchs, investors in Gabriel, filed substantially similar individual actions, which have been coordinated with the class action.[1]

Merkin was the general partner of Ascot and Gabriel, and GCC was the investment advisor to Ariel. The Funds in turn invested with Bernard L. Madoff Investment Securities (together with the individual Bernard L. Madoff, "Madoff"). The reported value of the Funds' assets, and thus the value of Plaintiffs' investments in the Funds, dropped significantly on December 11, 2008, when Merkin learned that the Funds were victims (indeed, among the largest victims) of Madoff's massive Ponzi scheme. Prior to December 11, 2008, Madoff had been a well-respected money manager and broker-dealer who had been delegated investment

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[1] Because the legal arguments mandating dismissal of all three actions are substantially the same, Defendants respectfully submit this single brief rather than burdening the group with three separate memoranda. Unless otherwise noted (where the differences between the allegations in the actions are relevant), all references herein are to the allegations of the TAC.

discretion over substantially all of Ascot's assets as well as a smaller portion of Gabriel's and Ariel's assets.

Notably, the TAC does not and cannot allege that Merkin or GCC knew about, much less participated in, the Madoff fraud. To the contrary, Merkin personally was a significant investor in the Funds and thus was himself among Madoff's many victims. Nor do Plaintiffs dispute that the delegation to Madoff was expressly permitted by the Offering Memoranda governing Plaintiffs' investments in the Funds. Indeed, NYLS admits that Merkin told its finance committee in November 2006 that at least a portion of Ascot was invested with Madoff.

Plaintiffs acknowledged that they were highly sophisticated investors known as "qualified purchasers" -- individuals or entities with investment assets of more than $5 million for individuals or more than $25 million for most entities -- who understood the risks associated with investing in hedge funds. Plaintiffs represented in their subscription documents that (i) they had reviewed the Funds' respective Offering Memoranda, (ii) they had had an opportunity to ask questions of Merkin and obtain other relevant information, and (iii) after conducting their own due diligence, their decisions to invest were the result of their independent investigations.

Nevertheless, the TAC alleges that Defendants failed to disclose the Funds' investments with Madoff -- something Defendants were expressly not required to do -- or should have performed better due diligence in connection with such investments. As a result, Plaintiffs seek to hold Merkin and GCC responsible for the decline in the value of the Funds following the revelation of the Madoff fraud. The TAC asserts seven claims against Merkin and GCC, for violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), as well as common law claims for breach of fiduciary duty, gross negligence, unjust

enrichment, fraud, and negligent misrepresentation. The Croscill and Fuchs Complaints also add a claim for breach of contract.

As demonstrated below, this Court should dismiss Plaintiffs' Section 10(b) claim because the TAC fails to allege a material misrepresentation because the governing documents expressly permitted the investments of which Plaintiffs complain; fails to allege scienter because Merkin did not have the motive to commit fraud and his own losses of more than $100 million refute any suggestion of fraudulent intent; fails to allege reasonable reliance or loss causation; and, as to Ariel, fails to allege a purchase or sale of securities within the United States, a required element of the claim because Section 10(b) does not apply extraterritorially. *See infra* Point I. The Section 20(a) claim for control person liability is defective because there is no underlying violation of Section 10(b); because Plaintiffs fail to plead Defendants' culpable participation in any alleged fraud; and, as to Ariel, because Plaintiffs fail to allege a purchase or sale of securities within the United States. *See infra* Point II.

Upon dismissing the federal securities law claims, this Court should decline to exercise supplemental jurisdiction over Plaintiffs' common law claims and should therefore dismiss those claims. *See infra* Point III. Moreover, the common law claims all fail as a matter of law for several independent reasons:

- The Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preempts Plaintiffs' state law claims. *See infra* Point III(A).
- The Martin Act preempts Plaintiffs' common law claims for breach of fiduciary duty, gross negligence, unjust enrichment, and negligent misrepresentation. *See infra* Point III(B).
- Madoff's massive fraud was a superseding criminal cause that bars all of Plaintiffs' state law claims for lack of causation. *See infra* Point III(C).
- The common law fraud claim suffers the same defects as the federal securities fraud claims -- failure to allege a misrepresentation or omission, scienter, reasonable reliance, and causation. *See infra* Point III(D).

- The exculpatory provisions of the Funds' governing documents bar the claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation. *See infra* Point III(E).

- The breach of fiduciary duty claim fails because the limited partnership agreements and investment advisory agreement permitted the delegation that Plaintiffs now claim to have been a breach of fiduciary duty and because Defendants did not owe Ariel shareholders a fiduciary duty. *See infra* Point III(F).

- The gross negligence claim fails because the claim is nothing more than a breach of contract claim disguised in tort language. *See infra* Point III(G).

- The unjust enrichment claim should be dismissed because it is premised entirely on the terms of the limited partnership agreements and investment advisory agreement, and it is well-settled that no quasi-contractual claim lies where there is an express contract between the parties. *See infra* Point III(H).

- The negligent misrepresentation claim also fails for failure to plead reasonable reliance or causation. *See infra* Point III(I).

- The breach of contract claim by Croscill and Fuchs fails because the Offering Memorandum is not a contract. *See infra* Point III(J).

Accordingly, this purported class action lawsuit should be dismissed in its entirety with prejudice.

Statement of Facts[2]

Ascot and Gabriel are Delaware limited partnerships that were formed to operate as private investment partnerships for U.S. investors, while Ariel is a Cayman Island corporation whose investors are exclusively non-U.S. persons and certain tax-exempt U.S. persons. (*See*

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[2] This Statement of Facts is drawn from the allegations of the TAC, which are accepted as true solely for purposes of this motion, as well as from documents referenced in the TAC, and other facts of which the Court may take judicial notice, including facts omitted from the TAC that are "not subject to reasonable dispute [because they are] . . . capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned," all of which may be considered on a motion to dismiss. Fed. R. Evid. 201(b)(2); *see also, e.g., Kramer v. Time Warner Inc.*, 937 F.2d 767, 773-74 (2d Cir. 1991); *Harrison v. Rubenstein*, No. 02 Civ. 9356, 2007 WL 582955, at *10 (S.D.N.Y. Feb. 26, 2007) (Batts, J.); *Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 607 n.4 (S.D.N.Y. 2008) (considering prospectuses, limited partnership agreements, and subscription documents in ruling on a motion to dismiss even though they were not attached to the complaint). The documents cited herein are annexed as exhibits to the Declaration of Gary J. Mennitt ("Mennitt Decl."), dated August 2, 2010, submitted herewith.

Ascot Offering Memorandum (Declaration of Gary J. Mennitt ("Mennitt Decl."), Ex. A) ("Ascot OM") at i, 1; Gabriel Offering Memorandum (Mennitt Decl., Ex. B) ("Gabriel OM") at i, 1; Ariel Offering Memorandum (Mennitt Decl., Ex. C) ("Ariel OM") at i, 1.) Gabriel and Ariel typically invested together in the same investments. (Ariel OM at i, 1, 20; Gabriel OM at ii, 1, 14.) At all relevant times, Merkin served as the General and Managing Partner of Gabriel and Ascot, and GCC served as the Investment Advisor to Ariel. (Gabriel OM at i, 1; Ascot OM at i, 1; Ariel OM at i, 1.)

During the proposed class period, Plaintiff NYLS invested $3 million in Ascot, Plaintiff Berrie invested $500,000 in Gabriel, Plaintiff Finkelstein invested $500,000 in Ariel, and Plaintiff Nephrology invested $1 million in Ariel. (*See* Compl. ¶¶ 20-23.) Croscill invested $2 million in Gabriel in April 1998. (Croscill Compl. ¶ 15.) Fuchs invested $10.135 million in Gabriel in January 2006. (Fuchs Compl. ¶ 15.)

Plaintiffs, like all investors in Ascot, Gabriel or Ariel, invested pursuant to the Funds' Offering Memoranda and signed Subscription Agreements and related documents in connection with their investments. (*See* Ascot Subscription Agreement (Mennitt Decl., Ex. D); Gabriel Subscription Agreement (Mennitt Decl., Ex. E); Ariel Subscription Agreement (Mennitt Decl., Ex. F) (collectively "Subscription Agreements").)

By entering into these Subscription Agreements, Plaintiffs agreed that their investments would be subject to the terms of the applicable Offering Memorandum, the Subscription Agreements themselves, and the relevant Limited Partnership Agreement or Investment Advisory Agreement. (Ascot Limited Partnership Agreement (Mennitt Decl., Ex. G); Gabriel Limited Partnership Agreement (Mennitt Decl., Ex. H) (collectively "LPAs"); Ariel Investment Advisory Agreement (Mennitt Decl. Ex. I) ("IAA," and collectively with the Offering

Memoranda, Subscription Agreements, and LPAs the "Governing Documents").) Further, investors represented that, prior to determining whether to invest, they had "received, carefully read and under[stood] the Partnership Agreement and the Memorandum outlining . . . the organization and investment objectives and policies of, and the risks and expenses of an investment in, the Partnership." (Ascot Subscription Agreement at 5; *see also* Gabriel and Ariel Subscription Agreements at 5.)

Plaintiffs, and all other investors in the Funds, acknowledged that they had "such knowledge and experience in financial and business matters that [they were] capable of evaluating the merits and risks of [their] investment[s] in the Partnership[s] and [were] able to bear such risks." (*Id.*) Further, Plaintiffs represented and covenanted that they had "evaluated the risks of investing in the Partnership, under[stood] there [we]re substantial risks of loss incidental to the purchase of Interests and ha[d] determined that the Interests [we]re a suitable investment." (*Id.*)

Each Plaintiff represented that it "made an independent decision to invest in the Partnership and that, in making its decision to subscribe . . . [it] relied solely upon the Memorandum, the Partnership Agreement and [its] independent investigations." In the same provision, each Plaintiff specifically acknowledged that it was "not relying on the Partnership, the General Partner . . . or any other person or entity . . . other than [its] own advisers." (*Id.*)[3]

Notwithstanding these detailed disclaimers, the TAC asserts that Plaintiffs invested in the Funds in reliance on numerous purported misrepresentations that are belied by the Offering Memoranda themselves. For example, Plaintiffs allege that the Offering Memoranda

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3 Ariel investors made the same representations, although Ariel's Subscription Agreement used terms appropriate for Ariel's corporate structure, for instance substituting "Fund" for "Partnership." (*See* Ariel Subscription Agreement at 5.)

misrepresented that Merkin personally conducted all of the Funds' investment activity. The Offering Memoranda in fact contain no such representation. To the contrary, the Offering Memoranda expressly advised investors that when Merkin delegated funds to third-party managers, those managers would be making the day-to-day "investment decisions" regarding those portions of the Funds. (Ascot OM at 2, 12-13; Gabriel OM at 2, 14; *see also* Ariel OM at 2, 20.) Nonetheless, Plaintiffs attempt to concoct their baseless claim from three statements – (i) that Merkin would devote substantially all of his time and effort during business hours to management of the Funds and other funds that he managed;[4] (ii) that the Funds would be wound down in the event he was unable to continue to do so; and (iii) that the success of the Funds depended on Merkin. Plaintiffs make no effort to explain why or how they could plausibly have believed that these requirements amounted to a representation that he alone would make all investment decisions for the Funds especially in light of the contrary representations in the Offering Memoranda.

The TAC repeatedly alleges that the Offering Memoranda "falsely stated that Merkin was involved in the Fund's management on a day-to-day and transaction-by-transaction basis." (Compl. ¶ 55; *see also id.* ¶¶ 89, 96, 100.) In fact, the Offering Memoranda make no such representation. To the contrary, the Offering Memoranda expressly advise prospective investors of Merkin's intention to delegate investment discretion for all or a portion of each Fund's assets to third-party managers; Merkin retained overall responsibility for selecting and monitoring

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4 Plaintiffs misleadingly omit portions of the relevant provisions of the Offering Memoranda, alleging, for instance, that the Ascot OM states that "[t]he General Partner has agreed to devote substantially his entire time and effort during normal business hours to the management of the [Ascot] Partnership …." (Compl. ¶ 57.) In fact, the rest of that sentence in the OM reads, "and other investment entities managed by the General Partner," and goes on to discuss potential conflicts of interest. (Ascot OM at 27; *see also* Compl. ¶ 91 (Gabriel); Gabriel OM at 30.). The full quotations from the OMs provide no basis to infer that Merkin was representing that he would be involved in the day-to-day and transaction-by-transaction management of the Funds.

those third-party managers. (Ascot OM at 2, 12-13; Gabriel OM at 1-2, 14; Ariel OM at i, 1-2, 20.) The Offering Memoranda further warned that:

> When the Partnership engages in investments through Other Investment Entities, . . . the General Partner will retain overall investment responsibility for the portfolio of the Partnership (although not the investment decisions of any independent money managers managing Other Investment Entities).

(Ascot OM at 2, 12-13; Gabriel OM at 2, 14; *see also* Ariel OM at 2, 20.) The LPAs and IAA also established that Merkin could invest the Funds' assets with outside money managers. (*See* Ascot LPA §§ 7.01, 7.03; Gabriel LPA § 7.01 (permitting the General Partner to delegate investment discretion to outside money managers); Ariel IAA at 9 (permitting the Investment Advisor to invest funds with outside money managers).)

The Offering Memoranda devote an entire section to Merkin's authority to delegate investment discretion and the risks associated with such delegation. These sections were prominently labeled "Independent Money Managers" within the risk disclosures of the Offering Memoranda. The section in the Ascot Offering Memorandum reads as follows:

> Independent Money Managers. The General Partner may delegate investment discretion for all or a portion of the Partnership's funds to money managers, other than the General Partner, or make investments with Other Investment Entities. Consequently, the success of the Partnership may also be dependent upon other money managers or investment advisors to Other Investment Entities. Although the General Partner will exercise reasonable care in selecting such independent money managers or Other Investment Entities and will monitor the results of those money managers and Other Investment Entities, the General Partner may not have custody over the funds invested with the other money managers or with Other Investment Entities. Hence, the actions or inactions on the part of other money managers or the investment advisors to Other Investment Entities may affect the profitability of the Partnership. The risk of loss of the funds invested with other money managers or with Other Investment Entities may not be insured by any insurance company, bonding company, governmental agency, or other entity and the General Partner is not liable for any such loss. Independent money managers and

> managers of Other Investment Entities selected by the General Partner may receive compensation based on the performance of their investments.

(Ascot OM at 17.) The Gabriel and Ariel Offering Memoranda contain substantially similar disclosures expressly warning investors of the very risk that occurred. (Gabriel OM at 28; Ariel OM at 40-41.) The Offering Memoranda further disclosed that the Funds could engage such independent money managers "without prior notice to" or the "consent of" the Funds' investors. (*See* Ascot OM at 2, 13; Gabriel OM at 2, 14; Ariel OM at 2, 20.) Moreover, although Defendants were under no obligation to identify the outside money managers, the Ascot Offering Memorandum specifically and explicitly identified Madoff as a prime broker and custodian in two places. (Ascot OM at 8, 28.)

The TAC is devoid of any factual support for the conclusory allegations that Merkin failed to perform appropriate due diligence or exercise reasonable care in selecting Madoff as an independent money manager. Thousands of sophisticated investors relied on Madoff, who had been the chairman of NASDAQ, an enormously successful broker-dearer who had started the first electronic exchange with Morgan Stanley, Goldman Sachs, Merrill Lynch, and Citigroup, and a frequent witness before Congress and the SEC. Furthermore, Madoff, who was regularly inspected by the SEC and the NASD, had an impeccable 20-year history of redemptions with the Funds.

Finally, the TAC alleges that the Ascot Offering Memorandum misrepresented that fund's "Investment Program." But the Ascot Offering Memorandum described as the primary investment strategy precisely what Merkin and the rest of the investing world understood to be the strategy that Madoff claimed to employ -- investments in a "diverse portfolio of securities" that involved "index arbitrage" with a "portfolio of large-cap U.S. equities drawn from the S&P 100" invested by "third-party managers, using managed accounts." (Compl. ¶¶ 61, 62.)

Likewise, Madoff's purported strategy was well within the description of the Investment Program for Gabriel and Ariel -- it involved a "diverse portfolio of securities" and "index arbitrage" conducted by a "third-party managers." (Compl. ¶ 92 (Gabriel); Ariel OM at i, 1-2, 20.) Nor did the delegation to Madoff violate the concentration limits in the Gabriel or Ariel Offering Memoranda (Compl. ¶¶ 93, 103), because no single investment believed to have been made by Madoff came close to the permissible limit of the greater of 50% of the Fund's capital or 25% of its total assets, nor did any Madoff investment put at risk more than 10% of the Fund's capital.

Argument

To survive a motion to dismiss pursuant to Rule 12(b)(6), a complaint must plead "enough facts to state a claim to relief that is plausible on its face." *Ruotolo v. City of New York*, 514 F.3d 184, 188 (2d Cir. 2008) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)); *see also Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) ("A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."); *id.* at 1953 (noting that *Twombly*'s standard of plausibility applies to all civil actions). Additionally, fraud-based claims must be pled with particularity pursuant to Rule 9(b) of the Federal Rules of Civil Procedure.

POINT I

THE THIRD AMENDED COMPLAINT FAILS TO STATE A SECTION 10(B) CLAIM

A claim for a violation of Section 10(b) of the Exchange Act requires Plaintiffs to plead, and ultimately to prove at trial, (1) a material misrepresentation or omission by the defendant; (2) in connection with the purchase or sale of a security; (3) scienter; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *See Dura Pharms.*,

Inc. v. Broudo, 544 U.S. 336, 341-42 (2005). These elements must be pled with specificity. *See ECA, Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 196 (2d Cir. 2009) ("Any complaint alleging securities fraud must satisfy the heightened pleading requirements of the PSLRA [Private Securities Litigation Reform Act] and Fed. R. Civ. P. 9(b) by stating with particularity the circumstances constituting fraud." (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320-21 (2007))). The Section 10(b) claim against Merkin and GCC falls far short of this exacting standard.[5]

A. The TAC Fails To Allege An Actionable Misrepresentation Or Omission

As an initial matter, the Section 10(b) claim cannot stand because Plaintiffs do not identify any misrepresentation or omission in connection with their decisions to invest in the Funds. Rather, the Offering Memoranda disclosed that the Funds would engage in the type of investment strategies that Madoff purported to be conducting, through a third-party manager, and the risks inherent in any such investment. The Second Circuit has consistently affirmed dismissal of securities claims at the pleading stage where, as here, the offering memorandum sets forth the facts alleged to have been omitted or misrepresented and "warn[s] investors of exactly the risk the plaintiffs claim was not disclosed." *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996); *see also Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 360 (2d Cir. 2002) ("The cautionary language addresses the relevant risk directly, and therefore neither offering memorandum was misleading.").

The Offering Memoranda advised, for example:

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[5] Croscill's Sections 10(b) and 20(a) claims are barred by the absolute five-year statute of limitations for Exchange Act claims, and should be dismissed for that additional, independent reason. *See* 28 U.S.C. § 1658(b).

- "The General Partner may delegate investment discretion for all or a portion of the Partnership's funds to money managers, other than the General Partner" (Ascot OM at 17; Gabriel OM at 28);

- "The Investment Advisor may delegate investment discretion for all or a portion of the Fund's funds to money managers, other than the Investment Advisor" (Ariel OM at 40-41);

- "When the Partnership engages in investments through Other Investment Entities, . . . the General Partner will retain overall investment responsibility for the portfolio of the Partnership (although not the investment decisions of any independent money managers managing Other Investment Entities)" (Ascot OM at 2, 12-13; Gabriel OM at 2, 14; *see also* Ariel OM at 2, 20);

- "[T]he General Partner may not have custody over the funds invested with the other money managers or with Other Investment Entities. Hence, the actions or inactions on the part of other money managers or the investment advisors to Other Investment Entities may affect the profitability of the partnership. The risk of loss of the funds invested with other money managers or with Other Investment Entities may not be insured by any insurance company, bonding company, governmental agency or other entity and the General Partner is not liable for any such loss." (Ascot OM at 17); and

- "[T]he General Partner may not have custody over the funds invested with the other money managers or with Other Investment Entities. The risk of loss of the funds invested with other money managers or with Other Investment Entities may not be insured by any insurance company, bonding company, governmental agency, or other entity and the General Partner is not liable for any such loss." (Gabriel OM at 28; *see also* Ariel OM at 41.)

In the face of these explicit disclosures, the TAC's assertion that the Offering Memoranda represented that Merkin would manage the Funds' investments on a "day-to-day" and "transaction-by-transaction" basis is frivolous. Furthermore, the Offering Memoranda disclosed not only the fact that investment discretion would be delegated to other money managers, but also the heightened risks associated with delegating assets to such outside managers, including Merkin's lack of custody over such assets. It is axiomatic that Plaintiffs cannot base a Section 10(b) claim on the materialization of these very risks. *See Olkey*, 98 F.3d at 5, 7; *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 762-63 (2d Cir.

1991) (statement in prospectus was not materially misleading where other sections of prospectus explicitly set forth the fact that plaintiff claimed was concealed).

Even if contradictory statements were made elsewhere in the Offering Memoranda or in other documents or presentations (which they were not), the specific risk disclosures in the Offering Memoranda defeat Plaintiffs' Section 10(b) claim. *See Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 334 (S.D.N.Y. 1993) (dismissing RICO claim based on Section 10(b) violation because, *inter alia*, the inferences on which plaintiffs relied were contradicted by more specific disclosures in the offering memorandum); *see also In re Hyperion Sec. Litig.*, No. 93 CIV. 7179, 1995 WL 422480, at *8 (S.D.N.Y. July 14, 1995) ("[P]laintiffs cannot predicate their claims on inferences drawn from statements made during the roadshows, if, as here, those inferences are contradicted by specific disclosures in the prospectuses."), *aff'd sub nom. Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2 (2d Cir. 1996); *Marlow v. Gold*, No. 89 Civ. 8589, 1991 WL 107268, at *9 (S.D.N.Y. June 13, 1991) (reasonable investor would not disregard written warnings in reliance on oral assurances); *Brown v. E.F. Hutton Group*, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990) (statements in sales brochure directly refuted by prospectus cannot form basis for federal securities law claim), *aff'd*, 991 F.2d 1020 (2d Cir. 1993).[6]

To the extent Plaintiffs attempt to state a Section 10(b) claim based on an alleged failure to disclose Madoff's role as an independent money manager for the Funds, such claim is fatally flawed because Defendants were expressly not required to disclose the identities of outside money managers. The Offering Documents, which each investor represented he or she had read

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[6] Plaintiffs' attempt to base their Section 10(b) claim on quarterly letters and post-investment representations (*see, e.g.*, Compl. ¶¶ 70-77, 110-20) also fails, because alleged misrepresentations occurring after the decision to invest cannot satisfy the "in connection with the purchase or sale of any security" requirement of Section 10(b). *See First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 869 F.2d 175, 180 n.2 (2d Cir. 1989) ("[P]laintiffs suing under Section 10(b) of the Securities Exchange Act of 1934 may recover only for losses that result from decisions to buy or to sell, not from decisions to hold or refrain from trading.").

and understood, warned each investor that the Funds would not give "notice" of or seek investor "consent" to such third-party managers. Defendants disclosed the use of outside money managers and the risks associated with such use. Nothing more was required. (*See* Ascot OM at 2, 13 ("The Partnership may withdraw from or invest in different investment funds and terminate or enter into new investment advisory agreements without prior notice to or consent of the Limited Partners . . . ."); Gabriel OM at 2, 14 (same); Ariel OM at 2, 20 (substantially the same).) "Silence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

Furthermore, any claim that Madoff's involvement with Ascot was not properly disclosed is undermined by that fund's twice identifying Madoff as a "prime broker[] and custodian[] for the Partnership" (Ascot OM at 8, 28), and twice describing the S&P 100 split-strike conversion strategy, Madoff's reported strategy, as the primary focus of Ascot's "Investment Program" (Ascot OM at 1-2, 12). Indeed, the losses at issue here occurred as a result of Madoff's custody over Ascot's assets, which was disclosed, not as a result of Madoff's purportedly making investment decisions on behalf of Ascot. Thus, Ascot's disclosure of Madoff as a custodian reinforces the fatal shortcomings of Plaintiffs' Section 10(b) claim. *See Halperin*, 295 F.3d at 360; *Olkey*, 98 F.3d at 5; *Hoffman v. UBS-AG*, 591 F. Supp. 2d 522, 535 (S.D.N.Y. 2008) (rejecting plaintiffs' assertion that, under Section 10(b), defendants had a duty to disclose all information about a particular arrangement once they disclosed the possibility of entering into the arrangement).

B. <u>The TAC Does Not Plead Facts Giving Rise To A Strong Inference Of Scienter</u>

Plaintiffs' Section 10(b) claim fails for the independent reason that it does not adequately allege scienter. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Tellabs*, 551 U.S. at 319 (quotations omitted). The PSLRA requires plaintiffs who allege

misstatements or omissions in violation of Section 10(b) to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Under *Tellabs*, "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." 551 U.S. at 323. "A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324. The Second Circuit permits plaintiffs to establish scienter in one of two ways: "(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001) (quotations omitted).

The TAC fails to plead scienter under either prong of the standard. The allegations that Merkin earned hundreds of millions of dollars in compensation as a result of the Funds' investments with Madoff are insufficient to satisfy the "motive and opportunity" test because the Second Circuit has unequivocally held that financial incentives possessed by all executives and managers do not constitute motive and opportunity. *See Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("[I]ncentive compensation can hardly be the basis on which an allegation of fraud is predicated." (alteration in original) (quotations omitted)); *Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 227 (S.D.N.Y. 2008) ("The desire to earn management fees is a motive generally possessed by hedge fund managers, and as such, does not suffice to allege a 'concrete and personal benefit' resulting from the fraud. To accept a generalized allegation of motive based on a desire to continue to obtain management fees would

read the scienter requirement out of the statute." (citation omitted)); *Vogel v. Sands Bros. & Co.*, 126 F. Supp. 2d 730, 739 (S.D.N.Y. 2001) (an investment bank's alleged desire to realize greater transaction fees is insufficient to show an improper motive).

Plaintiffs attempt to bolster the TAC's insufficient motive allegations by weakly alleging that Merkin had an incentive to delegate more of Gabriel's and Ariel's funds to Madoff rather than to other third-party money managers because others charged more fees than Madoff. This allegation fails for the same reason that Merkin's receipt of management fees is an insufficient motive. Plaintiffs are simply alleging that Merkin had an incentive to try to retain a greater management fee, a motivation possessed by every hedge fund manager, especially every hedge fund manager whose funds' governing documents, as here, permit him to delegate investment authority to third-party managers of his choosing at his discretion.

Moreover, Merkin's personal losses of more than $100 million in his investments in Gabriel, Ascot, and Ariel as a result of the Madoff fraud refute any notion that he acted with scienter by delegating investment responsibility to Madoff. *See Acito*, 47 F.3d at 54 (defendants' continued investment undermines a Section 10(b) claim); *Ressler v. Liz Claiborne, Inc.*, 75 F. Supp. 2d 43, 60 (E.D.N.Y. 1999) (defendants' continuous, substantial investment belies any inference of fraudulent intent), *aff'd sub nom. Fishbaum v. Liz Claiborne, Inc.*, 189 F.3d 460, No. 98-9396, 1999 WL 568023 (2d Cir. 1999) (unpublished); *see also In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 263 (S.D.N.Y. 2003) (dismissing Section 10(b) claim with prejudice and noting that "courts assume that defendants act in their 'informed self-interest'" and that computation of defendant's fees based on percentage of fund's assets "contradicts" the idea that defendant would purposely choose bad investments for the fund).

Nor do Plaintiffs allege scienter under the conscious misbehavior prong of the standard. As an initial matter, when a plaintiff relies on allegations of conscious or recklessness behavior, as opposed to motive and opportunity, "the strength of the circumstantial allegations must be correspondingly greater." *Faulkner v. Verizon Commc'ns, Inc.*, 189 F. Supp. 2d 161, 172 (S.D.N.Y. 2002) (quotation omitted). And here, Plaintiffs do not -- because they cannot -- allege that Merkin knew about, much less participated in, Madoff's fraud.

Furthermore, allegations of inadequate due diligence or lack of care in selecting an outside money manager -- even alleged failure to carry out a promised level of due diligence -- cannot form an actionable Section 10(b) claim. *See South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98, 111-13 (2d Cir. 2009). Madoff deceived the entire investing community, including the SEC, for many years.[7] Former Madoff executive Frank DiPascali has admitted in his plea allocution to, *inter alia*, conspiracy and securities fraud charges, that the Madoff operation used highly sophisticated techniques to avoid detection and perpetuate the massive fraud:

> On a regular basis I told clients . . . that transactions on national securities exchanges were taking place in their account when I knew that no such transactions were indeed taking place. I also took steps to conceal from clients, from the SEC, and from auditors the fact that no actual security trades were taking place and to perpetuate the illusion that they actually were.
>
> On a regular basis I used hindsight to file historical prices on stocks[,] then I used those prices to post purchase of sales to customer accounts as if they had been executed in real time.

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[7] According to published reports and to the SEC Office of Inspector General Report on which Plaintiffs purport to rely, Madoff defrauded thousands of sophisticated investors, and the SEC investigated Madoff on multiple occasions between 1992 and 2007 but did not detect the fraud. *See* Randall Smith, *Wall Street Mystery Features a Big Board Rival*, Wall Street Journal, Dec. 16, 1992, at C1; Binyamin Appelbaum, *Madoff Case "Failures" Put SEC in Spotlight*, Wash. Post, Dec. 19, 2008, at A1; *see also* Compl. ¶ 127; *SEC v. Cohmad Sec. Corp.*, No. 09 Civ. 5680, 2010 WL 363844, at *2 (S.D.N.Y. Feb. 2, 2010) ("[T]he complaint supports the reasonable inference that Madoff fooled the defendants as he did individual investors, financial institutions, and regulators.").

(DiPascali Plea Transcript, Aug. 11, 2009 (Mennitt Decl., Ex. J), at 47:9-19.) DiPascali also admitted to "falsifying documents that were required to be made and kept accurately under the SEC rules and regulations, including ledgers, trade blotters, customer statements, and trade confirmations." (*Id.* at 49:9-12.)

The TAC does not, because it cannot, overcome the only plausible inference -- that additional due diligence by Defendants would not have led them to uncover Madoff's Ponzi scheme. *See South Cherry Street*, 573 F.3d at 111-12 (affirming dismissal of Section 10(b) claim in part because Ponzi scheme perpetrators had deceived the entire investing community and, under the *Tellabs* standard, the complaint could not overcome the competing inference that defendants' due diligence would have been futile); *Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, No. 09 Civ. 3708, 2010 WL 1257567, at *6 (S.D.N.Y. Mar. 31, 2010) (dismissing Section 10(b) claim against auditors of Madoff feeder fund for lack of scienter because "the more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme and deceiving the SEC and other financial professionals"); *In re Tremont Sec. Law, State Law & Ins. Litig.*, --- F. Supp. 2d ----, No. 08-11212, 2010 WL 1257580, at *5 (S.D.N.Y. Mar. 30, 2010) (same); *see also Chill v. General Elec. Co.*, 101 F.3d 263, 265, 269-70 (2d Cir. 1996) (plaintiff did not adequately allege recklessness against parent with respect to fictitious trades entered into computerized system by employee of subsidiary, where plaintiff alleged that parent failed to investigate red flags at subsidiary, including unusually good results; "[f]raud cannot be inferred simply because [one] might have been more curious"); *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994) ("The [complaint] strongly suggests that the defendants should have been more alert and more skeptical, but nothing alleged indicates that management was promoting a fraud."); *Hart v.*

Internet Wire, Inc., 145 F. Supp. 2d 360, 365 (S.D.N.Y. 2001) (even a failure to heed "storm warnings" does not satisfy the scienter requirement).

In short, there is nothing in the TAC that gives rise to any inference, let alone the requisite strong inference, that the Defendants acted with a fraudulent intent. Plaintiffs' Section 10(b) claim should be dismissed for that reason alone. *See SEC v. Cohmad Sec. Corp.*, No. 09 Civ. 5680, 2010 WL 363844, at *3 (S.D.N.Y. Feb. 2, 2010) (dismissing SEC's Section 10(b) claim against a broker-dealer who referred investors to Madoff because complaint failed to plead facts giving rise to a strong inference of scienter); *see also MLSMK Invs. Co. v. JP Morgan Chase & Co.*, No. 09 Civ. 4049, 2010 WL 2925403, at *2-6 (S.D.N.Y. July 15, 2010).

C. <u>The TAC Does Not Allege Reasonable Reliance</u>

The explicit disclosures in the Offering Memoranda that the Funds would invest through outside money managers and the risks inherent in such investments also preclude Plaintiffs from alleging reasonable reliance on the alleged misrepresentations. *See Sable*, 819 F. Supp. at 338-39 (dismissing RICO claim based on Section 10(b) violation because it was unreasonable as a matter of law for plaintiffs to have relied on certain statements while disregarding explicit warnings); *Brown*, 735 F. Supp. at 1202 ("Reliance on statements which are directly contradicted by the clear language of the offering memorandum through which plaintiffs purchased their securities cannot be a basis for a federal securities fraud claim." (quotations omitted)). Plaintiffs decided to invest in the Funds knowing that all or a portion of the Funds would be placed with outside money managers, without prior notice to or approval of the investors in the Funds. (*See* Ascot OM at 2, 13; Gabriel OM at 2, 14; Ariel OM at 2, 20.) Plaintiffs cannot have reasonably believed, let alone relied upon, the notion that Merkin alone would manage their investments day-to-day or that he would not use third-party managers such as Madoff.

D. <u>The TAC Fails to Plead Loss Causation</u>

Plaintiffs' securities fraud claim should be dismissed for the additional reason that it fails to plead loss causation. The well-settled loss causation requirement exists precisely to prevent turning Defendants into insurers against all such loss. *See Dura Pharms.*, 544 U.S. at 343 ("To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires." (emphasis in original)); *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) (loss causation requirement is intended to "fix a legal limit on a person's responsibility, even for wrongful acts"). Securities fraud actions are available "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Dura Pharms.*, 544 U.S. at 345.

To satisfy the loss causation requirement, the TAC must allege facts to show that plaintiffs' economic losses occurred as a result of defendants' alleged omission or misrepresentation. *See* 15 U.S.C. § 78u-4(b)(4) (requiring that plaintiffs plead and prove that "the act or omission of the defendant alleged to violate [Section 10(b)] *caused the loss* for which the plaintiff seeks to recover damages" (emphasis added)); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172-73 (2d Cir. 2005) (discussing loss causation, including requirement that loss be foreseeable); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) ("To establish loss causation a plaintiff must show[] that the economic harm that it suffered *occurred as a result of* the alleged misrepresentations."); *Harrison v. Rubenstein*, No. 02 Civ. 9356, 2007 WL 582955, at *15 (S.D.N.Y. Feb. 26, 2007) (Batts, J.) (dismissing securities claims for failure to adequately plead loss causation).

Here, Plaintiffs allege in a conclusory manner that as a "proximate result" of Defendants' allegedly wrongful conduct, Plaintiffs suffered damages. (Compl. ¶ 233.) Such conclusory allegations are insufficient. As the world now knows, it was a massive Ponzi scheme perpetrated

by Bernard Madoff -- and nothing in the Offering Memoranda -- that caused Plaintiffs' losses. Indeed, the Offering Memoranda warned investors of the very custodial risk that was the cause of the loss. Since Plaintiffs do not, and cannot, plead that their economic losses were a foreseeable result of any statements made by Defendants, Plaintiffs do not state a claim under Section 10(b).

E. TAC Fails To State A Claim As To Ariel Because Section 10(b) Does Not Apply Extraterritorially And The TAC Fails To Allege A Sale Or Purchase Of Securities Within The United States

The Supreme Court recently held that Plaintiffs can bring a Section 10(b) claim only if the purchase or sale of securities occurred within the United States or on a domestic stock exchange. *See Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2884-86 (2010). Because Plaintiffs Finkelstein and Nephrology and other Ariel investors did not purchase any securities within the United States, they fail to state a claim under Section 10(b).

Morrison held that Section 10(b) applies "only [to] transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Id.* at 2884. The location of the transaction, not the location of the buyer or the allegedly deceptive conduct, controls whether Section 10(b) applies to a given sale or purchase of securities. *Id.* In adopting this bright-line transaction rule, the Supreme Court considered at length and explicitly rejected the Second Circuit's previous holdings that Section 10(b) may apply extraterritorially if "the wrongful conduct had a substantial effect in the United States or upon United States citizens" (the "effects test") or if "the wrongful conduct occurred in the United States" (the "conduct test"). *Id.* at 2879 (citing *SEC v. Berger*, 322 F.3d 187, 192-93 (2d Cir. 2003)); *id.* at 2881 (agreeing with criticism of these two tests and instead applying the presumption against extraterritoriality). As Justice Stevens noted in his concurrence in disagreeing with the Court's new rule, *Morrison* bars Section 10(b) claims where the purchases were made on a non-U.S. exchange, even if an alleged fraud is

implemented, or marketed to investors, in New York. *Id.* at 2895 (Stevens, J., concurring in the judgment). Justice Scalia's majority opinion does not object to Justice Stevens' characterization. *See also Cornwell v. Credit Suisse Group*, No. 08 Civ. 3758, 2010 U.S. Dist. LEXIS 76543, at *6-9 (S.D.N.Y. July 27, 2010) (holding that *Morrison* mandates dismissal of Section 10(b) claims of United States residents who invested in securities purchased on a foreign exchange, "unequivocally repudiated" the Second Circuit's conduct and effect tests, and "does not leave open any . . . back doors, loopholes or wiggle room . . . to overcome the decisive force of [its] ruling"). Precisely the same logic under *Morrison* applies to preclude claims based on offshore purchases of unregistered foreign securities.

Ariel is a Cayman Islands corporation. (Ariel OM at i, 1.) To subscribe, investors must send the Ariel subscription agreement to Ariel's Cayman Islands registrar, Fortis Prime Solutions (Cayman) Limited ("Fortis Cayman"). A new shareholder's investment is effective only when it is accepted by Fortis Cayman in the Cayman Islands. (*See* Ariel Subscription Agreement at 1, 25.) Thus, the purchases of Ariel interests occurred in the Cayman Islands, not in the United States. Accordingly, the claims of the Ariel Plaintiffs should be dismissed for this additional reason. *See Morrison*, 130 S. Ct. at 2884 ("[T]he presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case.")

POINT II

THE THIRD AMENDED COMPLAINT FAILS TO STATE A CLAIM FOR CONTROL PERSON LIABILITY

A claim for control person liability under Section 20(a) of the Exchange Act requires Plaintiffs to allege a primary violation by a controlled person and "culpable participa[tion]" by the alleged controlling person. *See Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998)

(quoting *S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996)). Because Plaintiffs have failed to allege an underlying violation of Section 10(b), they cannot state a claim under Section 20(a). *See In re Rhodia S.A. Sec. Litig.*, 531 F. Supp. 2d 527, 550 (S.D.N.Y. 2007) (Batts, J.) (dismissing Section 20(a) claim because there was no underlying Section 10(b) claim). In addition, the Section 20(a) claim fails because the TAC does not plead Defendants' "culpable participation" in any alleged underlying fraud. As this Court explained in *Harrison*:

> In order to state a claim under Section 20(a) Plaintiff must also plead "culpable participation" of the particular defendant in the alleged fraud. Where a complaint contains no detailed allegations regarding the state of mind of the "control person," a Section 20(a) claim must be dismissed for failure to allege culpable participation.

2007 WL 582955, at *19. That reasoning compels dismissal of the Section 20(a) claim here.[8]

POINT III

PLAINTIFFS' STATE LAW CLAIMS SHOULD BE DISMISSED

As a preliminary matter, the Court should decline to exercise supplemental jurisdiction over Plaintiffs' state common law claims upon dismissal of the defective federal securities law claims. *See* 28 U.S.C. § 1367(c)(3); *Cave v. East Meadow Union Free School Dist.*, 514 F.3d 240, 250 (2d Cir. 2008) (finding that because federal claims were dismissed the district court should not exercise supplemental jurisdiction over state law claims); *Baylis v. Marriott Corp.*, 843 F.2d 658, 665 (2d Cir. 1988) ("When all bases for federal jurisdiction have been eliminated from a case so that only pendent state claims remain, the federal court should ordinarily dismiss the state claims." (citing *United Mine Workers of Am. v. Gibbs*, 383 U.S. 715, 725 (1966))); *Makas v. Orlando*, No. 06-14305, 2008 WL 1985407, at *8 (S.D.N.Y. May 6, 2008) (Batts, J.) (declining to exercise jurisdiction over state law claims because all federal claims had been

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[8] Additionally, the Ariel Plaintiffs' Section 20(a) claim fails under *Morrison*, for the reasons discussed in Point I(E) *supra*.

dismissed). In the event the Court elects to exercise supplemental jurisdiction, the state law claims should be dismissed as a matter of law for numerous independent reasons.

A. The State Law Claims Are Preempted By SLUSA

Plaintiffs' state law claims are preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), and should therefore be dismissed. SLUSA mandates dismissal of (i) a covered class action; (ii) based on state law; (iii) alleging a material misrepresentation or omission; (iv) in connection with the purchase or sale of a covered security. *See* 15 U.S.C. §§ 78bb(f)(1), 77p(b); *Felton v. Morgan Stanley Dean Witter & Co.*, 429 F. Supp. 2d 684, 690-91 (S.D.N.Y. 2006). The present action meets all four requirements for SLUSA preemption.

First, Plaintiffs purport to bring their claims on behalf of a class of Ascot, Gabriel, and Ariel investors (Compl. ¶ 35), and thus easily meet the definition of a "covered class action," which is "a lawsuit in which damages are sought on behalf of more than 50 people." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 83 (2006). Second, Plaintiffs' claims for breach of fiduciary duty, gross negligence, unjust enrichment, fraud, and negligent misrepresentation are all based on state law. (Compl. ¶¶ 247-52, 264-88.) Third, Plaintiffs allege material misrepresentations and omissions. (*Id.*) Finally, the alleged misrepresentations and omissions are "in connection with the purchase or sale of a covered security." 15 U.S.C. §§ 78bb(f)(1), 77p(b). "A 'covered security' is one traded nationally and listed on a regulated national exchange." *Dabit*, 547 U.S. at 83.

SLUSA preempts all state law claims where a plaintiff invests directly or indirectly in covered securities, including where, as here, "the fraud alleged 'coincide[s]' with a securities transaction -- whether by the plaintiff or by someone else." *Id.* at 85. Here, the Funds invested with Madoff, who in turn purported to buy and sell covered securities. (Compl. ¶ 46.) That satisfies the requirement of a connection to the purchase or sale of a covered security because

Plaintiffs' investments in the Funds "coincided" with securities transactions. That Madoff did not actually make the investments is of no import. *See Barron v. Igolnikov*, No. 09 Civ. 4471, 2010 WL 882890, at *5 (S.D.N.Y. Mar. 10, 2010) ("[For SLUSA preemption to apply,] [i]t is not essential that Madoff actually performed any trades or acquired any securities."); *id.* at *4 (citing cases). Accordingly, SLUSA preempts Plaintiffs' state law claims and they should be dismissed. *See id.* at *5 (finding that SLUSA preempted state law claims against funds of funds that invested with Madoff, including through Ascot, and dismissing complaint); *Levinson v. PSCC Servs., Inc.*, No. 3:09-CV-00269, 2009 WL 5184363, at *14 (D. Conn. Dec. 23, 2009) (dismissing state law claims against manager of fund that invested with Madoff as preempted by SLUSA).

B. Plaintiffs' Non-Fraud Common Law Claims Are Preempted By The Martin Act

New York law preempts Plaintiffs' non-fraud common law claims for breach of fiduciary duty, gross negligence, unjust enrichment, and negligent misrepresentation. The Martin Act provides the New York Attorney General with the exclusive authority to bring any common law claim arising from the purchase or sale of securities that does not require proof of scienter, and does not permit a private right of action for such claims.[9] *See CPC Int'l Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 276-77, 514 N.E.2d 116, 118-19 (1987) (no private right of action under the Martin Act); *see also Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 12 N.Y.3d 236, 244-47, 906 N.E.2d 1049, 1054-55 (2009).

[9] The New York Attorney General has already brought claims in New York state court, purportedly on behalf of all investors in Ascot, Gabriel, Ariel, and another fund, against Merkin and GCC for violation of the Martin Act arising out of the same events that give rise to this action. *See People v. Merkin*, Index No. 450879/2009 (Sup. Ct. N.Y. County); *see also Barron*, 2010 WL 882890, at *6 (finding that the Attorney General's case on behalf of Ascot, Gabriel, and Ariel investors "only underscores the appropriateness of Martin Act preemption" and granting motion to dismiss); *In re Tremont*, 2010 WL 1257580, at *7 (same).

Courts in this Circuit regularly dismiss as preempted by the Martin Act state law claims arising from the purchase or sale of a security that do not require proof of scienter and that involve conduct "within or from" New York. *See, e.g.*, *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001); *Stephenson v. Citco Group Ltd.*, No. 09 Civ. 00716, 2010 WL 1244007, at *13-14 (S.D.N.Y. Apr. 1, 2010) (dismissing breach of fiduciary duty, gross negligence, and negligence claims against administrator of Madoff feeder "fund of funds" as preempted by Martin Act); *In re Tremont*, 2010 WL 1257580, at *7-8 (dismissing non-fraud common law claims against auditors of Madoff feeder fund as preempted by Martin Act); *Barron*, 2010 WL 882890, at *5-6 (dismissing breach of fiduciary duty, gross negligence, and unjust enrichment claims against administrator of funds that invested with Madoff, including through Ascot, as preempted by Martin Act); *Kassover v. UBS AG*, 619 F. Supp. 2d 28, 36-39 (S.D.N.Y. 2008) (dismissing breach of fiduciary duty, negligent misrepresentation, and negligence claims as preempted by Martin Act); *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 421-22 (S.D.N.Y. 2007) (dismissing breach of fiduciary duty claim based on alleged failure to conduct due diligence as preempted by the Martin Act), *aff'd on other grounds*, *South Cherry Street*, 573 F.3d 98; *Pro Bono Invs., Inc. v. Gerry*, No. 03 Civ. 4347, 2005 WL 2429787, at *1, *16 (S.D.N.Y. Sept. 30, 2005) (holding breach of fiduciary duty, unjust enrichment, gross negligence, and negligent misrepresentation claims preempted by Martin Act).[10]

Hence, Plaintiffs' claims for breach of fiduciary duty, gross negligence, unjust enrichment, and negligent misrepresentation, which are based on the purchase of securities, do

[10] "[A] transaction qualifies as 'within or from' New York for purposes of the Martin Act if a plaintiff alleges that a substantial portion of the events giving rise to a claim occurred in New York." *In re Tremont*, 2010 WL 1257580, at *7 (citing *Sedona Corp. v. Ladenburg Thalmann & Co.*, No. 03 Civ. 3120, 2005 WL 1902780, at *22 (S.D.N.Y. Aug. 9, 2005), which "appl[ied] Martin Act where Complaint alleged proper venue in New York based on substantial part of the events or omissions giving rise to the claims occurred in the Southern District of New York").

not require proof of scienter, and arise out of events a substantial portion of which occurred in New York, are barred by the Martin Act and should be dismissed.[11]

C. Madoff's Fraud Constitutes A Superseding Criminal Cause That Bars Plaintiffs' State Law Claims For Lack Of Causation

Plaintiffs' state law claims require plausible allegations that the Defendants directly *and* proximately caused their losses. *See Laub v. Faessel*, 297 A.D.2d 28, 30-31, 745 N.Y.S.2d 534, 536 (1st Dep't 2002) (holding that direct and proximate causation are required elements of fraud, negligent misrepresentation, and breach of fiduciary duty claims, and citing cases); *see also Thorpe by Castleman v. CERBCO, Inc.*, 676 A.2d 436, 444 (Del. 1996) (breach of fiduciary duty); *Food Pageant, Inc. v. Consolidated Edison Co., Inc.*, 54 N.Y.2d 167, 172, 429 N.E.2d 738, 740 (1981) (gross negligence). Plaintiffs concede, however, that Madoff's Ponzi scheme was an intentional criminal act that caused their losses. (Compl. ¶¶ 1, 37-44.) Where, as here, "third-party criminal acts intervene between defendant's negligence and plaintiff's injuries, the causal connection may be severed, precluding liability." *Ingrassia v. Lividikos*, 54 A.D.3d 721, 724, 864 N.Y.S.2d 449, 452 (2d Dep't 2008) (quotations omitted); *see also Hart v. Resort Investigations & Patrol*, No. C.A. 01C-12-029, 2004 WL 2050511, at *9 (Del. Super. Ct. Sep. 9, 2004).

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11 Plaintiffs' claims for breach of fiduciary duty, gross negligence, and unjust enrichment should all be dismissed for the additional reason that Plaintiffs lack standing because those purported claims belong to the Funds and not to the limited partners or shareholders of the Funds individually. *See Stephenson*, 2010 WL 1244007, at *7-9 (dismissing claims against administrator of Madoff feeder fund of funds for lack of standing where claims alleged mismanagement and plaintiff could not prevail without showing injury to the fund itself); *West Palm Beach Pension Fund v. Collins Capital Low Volatility Performance Fund II, Ltd.*, No. 09 Civ. 80846, 2010 WL 2949856, at *3 (S.D. Fla. July 26, 2010); *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004); *Litman v. Prudential-Bache Props., Inc.*, 611 A.2d 12, 14-17 (Del. Ch. 1992) (dismissing claims brought by limited partners against general partner for lack of standing because such claims alleged mismanagement and were thus derivative). These settled standing principles are especially true here, where Receivers who have the power to bring claims on behalf of the Funds have been appointed and the New York Attorney General is already pursuing state law claims on behalf of investors in the Funds. *See People v. Merkin*, Index No. 450879/2009 (Sup. Ct. N.Y. County).

In the face of a superseding criminal act such as Madoff's, a defendant would be liable only if the crime were a "normal or foreseeable" consequence of the defendant's own actions. *See Derdiarian v. Felix Contracting Corp.*, 51 N.Y.2d 308, 315, 414 N.E.2d 666, 670 (1980). Madoff's criminal activity was anything but "normal or foreseeable." *See Santiago v. New York City Housing Auth.*, 63 N.Y.2d 761, 763, 469 N.E.2d 839, 840 (1984) (refusing to "stretch the concept of forseeability beyond acceptable limits" (quotations omitted)). Indeed, Madoff's Ponzi scheme is widely recognized as an unprecedented, historic fraud that even the SEC did not foresee. *See, e.g.*, *Cohmad*, 2010 WL 363844, at *2 (noting that "investors, financial institutions, and regulators" did not foresee Madoff's Ponzi scheme). Because Madoff's fraud -- not any alleged misconduct on the part of Defendants -- caused Plaintiffs' losses, all of Plaintiffs' state law claims should be dismissed.

D. Plaintiffs Fail To State A Claim For Common Law Fraud

Under New York law, a plaintiff claiming fraud must show "a misrepresentation or a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or material omission, and injury." *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421, 668 N.E.2d 1370, 1373 (1996); *see also Joffee v. Lehman Bros., Inc.*, No. 04 Civ. 3507, 2005 WL 1492101, at *14 (S.D.N.Y. June 23, 2005) ("The pleading requirements for common law fraud are essentially the same as those for claims under Section 10(b) and Rule 10b-5."); *In re Tremont*, 2010 WL 1257580, at *6 (dismissing common law fraud claim against auditors of Madoff feeder fund because Section 10(b) claim could not survive). Hence, the

common law fraud claim should be dismissed for the same reasons as the Section 10(b) claim. *See supra* Point I.[12]

E. The Exculpatory Provisions Of The Limited Partnership And Investment Advisory Agreements Bar The Breach Of Fiduciary Duty, Unjust Enrichment, And Negligent Misrepresentation Claims

In addition to being preempted by SLUSA and the Martin Act, Plaintiffs' breach of fiduciary duty, unjust enrichment, and negligent misrepresentation claims should be dismissed for the additional reason that the exculpatory provisions in the LPAs and IAA eliminate Plaintiffs' right to bring such claims. These exculpatory provisions limit Plaintiffs' recourse to cases of "bad faith, gross negligence, recklessness, fraud, or intentional misconduct." (Ascot and Gabriel LPAs § 7.04; *see also* Ariel IAA at 8.)[13]

Both New York and Delaware law recognize the enforceability of exculpatory provisions that eliminate liability for breach of fiduciary duty, unjust enrichment, negligence, and negligent misrepresentation claims. *See Kalisch-Jarcho, Inc. v. City of New York*, 58 N.Y.2d 377, 385-86, 461 N.Y.S.2d 746, 749-50 (1983) (explaining that exculpatory clauses are enforced unless they apply to conduct that is "willful or grossly negligent," "smacks of intentional wrongdoing," or "betokens a reckless indifference to right of others"); *see also In re DB Cos.*, No. 04-11618, 2008 WL 704417, at *1 (Bankr. D. Del. Mar. 14, 2008) (dismissing negligent misrepresentation

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12 Like the Section 10(b) claim, the common law fraud claim also fails to state a claim to the extent it attempts to rely on alleged misrepresentations that occurred after Plaintiffs had already invested. Such "holder" fraud claims are not cognizable under New York law. *See Starr Found. v. Am. Int'l Group*, 901 N.Y.S.2d 246, 248 (1st Dep't 2010).

13 The Ariel IAA provides that "the Investment Advisor shall not be liable to the Fund for mistakes of judgment or for action or inaction which said Investment Advisor reasonably believed to be in the best interests of the Fund, or for losses due to such mistakes, action or inaction or to the negligence, dishonesty or bad faith of any employee, broker or other agent of the Investment Advisor, provided that such employee, broker or agent was selected, engaged or retained by the Investment Advisor with reasonable care." (Ariel IAA at 8.) The agreement further states that this clause "shall not be construed so as to relieve . . . the Investment Advisor of any liability, to the extent (but only to the extent) that such liability may not be waived, modified or limited under applicable law . . . ." (*Id.*)

claim as barred by exculpatory provision); *Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P.*, No. Civ. A. 20066-N, 2006 WL 1494360, at *4 (Del. Ch. May 24, 2006) (finding that general partner was exculpated from liability for negligence under the partnership agreement); *Colnaghi, U.S.A., Ltd. v. Jewelers Prot. Servs. Ltd.*, 81 N.Y.2d 821, 823, 595 N.Y.S.2d 381, 382 (1993) ("New York law generally enforces contractual provisions absolving a party from its own negligence.").[14] Hence, Plaintiffs' breach of fiduciary duty, unjust enrichment, and negligent misrepresentation claims should be dismissed as barred by the very terms governing Plaintiffs' investment.

F. The TAC Does Not State A Claim For Breach Of Fiduciary Duty

Plaintiffs' breach of fiduciary duty claim cannot proceed for yet another reason: The LPAs and IAA expressly permitted the conduct that Plaintiffs now allege constituted a breach of fiduciary duty. (*See* Ascot and Gabriel LPAs § 7.01; Ascot LPA § 7.03; Ariel IAA at 9 (authorizing delegation of Fund assets to independent money managers).)

Delaware law provides that a general partner has not breached his fiduciary duties where, as here, he has complied with the terms of an express authorization in the relevant partnership agreement. *See* Del. Code Ann. tit. 6, § 17-1101(c). "A general partner acting in good faith reliance on the provisions of the partnership agreement is shielded from liability for breach of fiduciary duty." *U.S. Cellular Inv. Co. of Allentown v. Bell Atlantic Mobile Sys., Inc.*, 677 A.2d 497, 504 (Del. 1996) (affirming dismissal of breach of fiduciary duty claim because the

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14 In addition, under Delaware law (applicable to Ascot and Gabriel claims pursuant to the Ascot and Gabriel LPAs, § 11.06), partners in a limited partnership are empowered by statute to modify or eliminate liability for breach of fiduciary duty claims. Specifically, a limited partnership is free to eliminate "any and all liabilities for . . . breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner." Del. Code Ann. tit. 6, § 17-1101(f); *see also Sonet v. Timber Co., L.P.*, 722 A.2d 319, 322-24, 327 (Del. Ch. 1998) (dismissing breach of fiduciary duty claim against general partner as barred by exculpatory provision in partnership agreement).

complaint did not assert that defendant general partner was in knowing breach of the terms of the partnership agreement). Similarly, under New York law, a plaintiff cannot pursue a breach of fiduciary duty claim based on allegations of fiduciary wrongdoing that are "encompassed within the contractual relationship." *Brooks v. Key Trust Co. Nat'l Ass'n*, 26 A.D.3d 628, 630, 809 N.Y.S.2d 270, 272 (3d Dep't 2006) (citation omitted). Thus, because the LPAs and IAA expressly permitted delegation of investment discretion, Plaintiffs cannot premise a breach of fiduciary duty claim on that very delegation of authority.[15]

G. The TAC Fails To State A Claim For Gross Negligence

The Court should also dismiss the gross negligence claim because Plaintiffs do not allege conduct that amounts to gross negligence. Gross negligence "differs in kind, not only degree, from claims of ordinary negligence. It is conduct that evinces a reckless disregard for the rights of others or 'smacks' of intentional wrongdoing." *Colnaghi*, 81 N.Y.2d at 823-24, 611 N.E.2d at 284; *see also Gelfman v. Weeden Investors, L.P.*, 859 A.2d 89, 114 (Del. Ch. 2004) (gross negligence "involves a devil-may-care attitude or indifference to duty amounting to recklessness" (quotations omitted)).

Plaintiffs' gross negligence claim is based entirely on the premise that Defendants were careless in investing with Madoff. Far from engaging in any "intentional wrongdoing," by

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[15] In addition, Plaintiffs have not adequately pled that Ariel shareholders stood in a fiduciary relationship with Defendants. GCC's relationship with Ariel was prescribed by the IAA, a contract between GCC and Ariel. Ariel investors had no direct relationship with either GCC or Merkin, contractual or otherwise. Indeed, Plaintiffs have not alleged any facts to support transforming the relationship between Ariel's investment advisor and its shareholders into a fiduciary relationship. *See HF Mgmt. Servs. LLC v. Pistone*, 34 A.D.3d 82, 84, 818 N.Y.S.2d 40, 42 (1st Dep't 2006) ("[G]enerally no [fiduciary] relationship exists between those involved in arm's length business transactions." (citation omitted)); *see also Kopel v. Bandwidth Tech. Corp.*, 56 A.D.3d 320, 320, 868 N.Y.S.2d 16, 17 (1st Dep't 2008) (affirming dismissal of breach of fiduciary duty claim because no fiduciary relationship was created by "a simple business transaction between a potential investor and a company soliciting such investors"); *cf. Goldstein v. S.E.C.*, 451 F.3d 873, 881 (D.C. Cir. 2006) (investment adviser under Investment Advisers Act owes no fiduciary duty to investors in fund; in fact, any argument to the contrary "falls outside the bounds of reasonableness").

investing with Madoff, Defendants were acting in accordance with the express terms of the Funds' Governing Documents. Defendants' duties were set forth in and limited by the Governing Documents. Thus, any claim for breach of those duties sounds in contract, not tort. Plaintiffs cannot transform breach of contract allegations into a tort claim by asserting that Defendants were negligent or reckless in their performance of contractual duties. *See City of New York v. 611 W. 152nd St., Inc.*, 273 A.D.2d 125, 126, 710 N.Y.S.2d 36, 38 (1st Dep't 2000) ("[C]laims based on negligent or grossly negligent performance of a contract are not cognizable."); *Fluhr v. Goldscheider*, 264 A.D.2d 570, 571, 695 N.Y.S.2d 30, 31 (1st Dep't 1999) ("[N]o cause of action exists for negligent performance of a contract."); *Wapnick v. Seven Park Ave. Corp.*, 240 A.D.2d 245, 247, 658 N.Y.S.2d 604, 606 (1st Dep't 1997) (same).

It is also well-settled that a gross negligence claim should be dismissed where, as here, "plaintiff has not alleged the violation of a legal duty independent of the contract." *Clark-Fitzpatrick, Inc. v. Long Island R.R. Co.*, 70 N.Y.2d 382, 390, 516 N.E.2d 190, 194 (1987) (dismissing gross negligence claim where allegations were "merely a restatement, albeit in slightly different language, of the 'implied' contractual obligations asserted in the cause of action for breach of contract"); *see also Metro. W. Asset Mgmt., LLC v. Magnus Funding, Ltd.*, No. 03 Civ. 5539, 2004 WL 1444868, at *9 (S.D.N.Y June 25, 2004) (dismissing gross negligence claim where plaintiff "failed to allege any act or omission . . . that is not based on the requirements of" a contract between the parties); *Sargent v. New York Daily News, L.P.*, 42 A.D.3d 491, 493, 840 N.Y.S.2d 101, 103-04 (2d Dep't 2007) (dismissing negligence and gross negligence claims where "plaintiffs failed to allege or demonstrate that the defendants owed them a legal duty independent of the contractual duty"); *Wapnick*, 240 A.D.2d at 247, 658 N.Y.S.2d at 606 ("absent the allegation of a duty owed by defendant independent of the contract," gross

negligence claim was "fundamentally no more than a breach of contract claim" and should be dismissed).[16] Here, too, Plaintiffs' gross negligence claim is nothing more than a breach of contract claim framed in tort language and should therefore be dismissed.

H. Plaintiffs Fail To State A Claim For Unjust Enrichment

Plaintiffs' unjust enrichment claim is premised solely on the theory that the Funds paid management and incentive fees that should not have been paid to the extent they were based on the Funds' investments with Madoff. Any rights Plaintiffs may have concerning fees paid to the Defendants, however, are governed exclusively by the agreements between the parties, as set forth in the Governing Documents. Because Plaintiffs' rights, if any, are governed by contract, the quasi-contract claim of unjust enrichment cannot lie. "Generally, quasi-contractual relief, such as unjust enrichment, is not permitted when an express agreement exists that governs the dispute between the parties." *CSI Inv. Partners II, L.P. v. Cendant Corp.*, 507 F. Supp. 2d 384, 435 (S.D.N.Y. 2007) (Batts, J.) (quoting *Bridgeway Corp. v. Citibank N.A.*, 132 F. Supp. 2d 297, 305 (S.D.N.Y. 2001)); *see also Mid-Hudson Catskill Rural Migrant Ministry, Inc. v. Fine Host Corp.*, 418 F.3d 168, 175 (2d Cir. 2005) (affirming district court's dismissal of unjust enrichment claim because contract existed governing the subject matter of claim); *Goldman v. Metro. Life Ins. Co.*, 5 N.Y.3d 561, 572, 841 N.E.2d 742, 746 (2005) ("The theory of unjust enrichment lies as a quasi-contract claim. It is an obligation the law creates *in the absence of any agreement*." (emphasis added)); *Merin v. Precinct Developers LLC*, 74 A.D.3d 688, 902 N.Y.S.2d 821 (1st Dep't 2010) ("The cause of action for unjust enrichment is precluded by the existence of a valid agreement."). Because the Governing Documents encompass the subject matter of Plaintiffs'

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[16] Delaware law adheres to the same principle. *See McKenna v. Terminex Int'l Co.*, C.A. No.: 04C-02-022RBY, 2006 WL 1229674, at *3 (Del. Super. Ct. Mar. 13, 2006) (gross negligence claim cannot proceed where complaint "does not assert that Defendants breached a duty independent of the contract obligations, but merely alleges that Defendants' negligence rose to the level of gross negligence").

claims, *i.e.*, the management and incentive fees, those contracts preclude a claim of unjust enrichment.

I. Plaintiffs Fail To State A Claim For Negligent Misrepresentation

Plaintiffs' negligent misrepresentation claim fails for yet another reason: Like the Section 10(b) and common law fraud claims, a claim for negligent misrepresentation requires Plaintiffs to plead reasonable reliance and loss causation. *See Matsumura v. Benihana Nat'l Corp.*, 542 F. Supp. 2d 245, 251-52, 256-57 (S.D.N.Y. 2008) (holding that plaintiffs' negligent misrepresentation and breach of fiduciary duty claims are subject to Rule 9(b) and dismissing negligent misrepresentation claim for failure to plead reasonable reliance); *ESBE Holdings, Inc. v. Vanquish Acquisition Partners, LLC*, 50 A.D.3d 397, 398, 858 N.Y.S.2d 94, 95 (1st Dep't 2008) (affirming dismissal of negligent misrepresentation claim for failure to plead loss causation (citing *Laub*, 745 N.Y.S.2d at 536-37)); *see also Corporate Prop. Assocs. 14 Inc. v. CHR Holding Corp.*, C.A. No. 3231-VCS, 2008 WL 963048, at *8 (Del. Ch. Apr. 10, 2008) (under Delaware law, the elements of a negligent misrepresentation claim parallel those of a fraud claim, except for state of mind). Because the TAC does not adequately allege reasonable reliance or loss causation, the negligent misrepresentation claim falls on this ground as well.

J. Croscill And Fuchs Fail To State A Claim For Breach Of Contract

Finally, Croscill's and Fuchs's attempt to transform their insufficient fraud allegations into a breach of contract claim by alleging that the Gabriel Offering Memorandum constituted an "implied agreement" also fails. The Offering Memorandum is simply not a contract and therefore does not give rise to a claim for breach of contract by Croscill or Fuchs.

Conclusion

For the foregoing reasons, Plaintiffs' Third Consolidated Amended Class Action Complaint should be dismissed in its entirety, with prejudice.

Dated: New York, New York
August 2, 2010

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