UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re J. EZRA MERKIN AND BDO SEIDMAN SECURITIES LITIGATION	No. 08 Civ. 10922 (DAB)

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

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Lead Plaintiffs New York Law School ("NYLS"), Scott Berrie ("Berrie") and Jacob E. Finkelstein CGM IRA Rollover Custodian ("Finkelstein") (together the "Plaintiffs"), investors that purchased limited partnership interests in Ascot Partners, L.P. (the "Ascot Fund") or Gabriel Capital, L.P. (the "Gabriel Fund"), or shares in Ariel Fund Limited (the "Ariel Fund") (collectively, the "Funds"), respectfully submit this memorandum of law in opposition to the motion to dismiss the Third Consolidated Amended Class Action Complaint (the "TAC") filed by Defendants J. Ezra Merkin ("Merkin") and Gabriel Capital Corporation ("GCC")(together the "Defendants").

PRELIMINARY STATEMENT

This case stems from the massive fraudulent scheme perpetrated by Bernard L. Madoff ("Madoff") through his investment firm Bernard L. Madoff Investment Securities, LLC ("BMIS"). Madoff's fraud was facilitated, either knowingly or with extreme recklessness, by Merkin and his company GCC. Merkin created the Funds in which class members invested and had sole responsibility for the management, operations and investment decisions of those Funds. Over the course of many years, Merkin, both directly and through GCC, funneled billions of dollars to Madoff, including the entirety of the assets of the Ascot Fund which had been created by Merkin (unbeknownst to its investors) for the sole purpose of transferring its investors' money directly to Madoff and over 25% of the nearly $3 million in assets of the "sister" Gabriel and Ariel Funds. While Merkin was blindly handing money over to Madoff, he overtly misled investors into believing that he was actively managing the assets of the Funds pursuant to a very specific investment strategy and was actively monitoring any third-party investment advisors which he represented he had carefully researched and chosen.

In return for providing grist for Madoff's mill, defendant Merkin was rewarded handsomely, and wholly unjustly, in the form of hundreds of millions of dollars in

"management" fees and incentive payments. These management fees were paid to Merkin to "manage" the Funds, yet Merkin did no more than hand over the bulk (and in the cases of Ascot, all) of the Funds' assets to Madoff. Similarly, any incentive awards paid to Merkin were completely unearned because they were based solely on fictitious returns from Madoff. There is simply no justification – legal, factual or otherwise – for allowing Merkin to keep hundreds of millions of dollars in ill-gotten gains and not to compensate investors in these three Funds for the losses they suffered as a consequence of Merkin's misconduct.

In the face of the massive amount of money flowing directly and solely to him, Merkin knowingly perpetuated the myth that he was handling or overseeing the investment of the Funds' assets and, at the same time, recklessly or consciously disregarded obvious warning signs that should have alerted him to the Madoff fraud. The list of red flags, as detailed in the TAC, is endless and should have put any investment manager in the same position as Merkin on notice of a fraud – the red flags were that obvious. Merkin was not a bystander, an analyst, an independent advisory firm or even the SEC, Merkin was knee deep with Madoff, funneling a huge portion of the total assets of the Funds directly to Madoff. Any competing inference of innocent conduct espoused by Defendants in connection with this motion -- *e.g.*, that somehow Merkin, a sophisticated investment advisor was bamboozled by Madoff -- is not as compelling as the inference that Merkin knew exactly what he was doing or consciously disregarded obvious signs that all was not right with Madoff and BMIS.

Despite the detailed allegations of the TAC and despite the failure of Merkin to have similar claims against him dismissed in related actions arising out of the same set of facts,[1]

[1] In addition to the various cases cited herein where Merkin has failed to have claims against him dismissed, Merkin was found liable in two arbitrations brought by Fund investors to date. *See Wiederhorn v. Merkin*, Case No. 13 148 Y 02937 08 (American Arbitration Association May 12, 2010) (*See* Brown Dec. Ex. 1); *Wiederhorn v. Merkin*, No. 601265/2010 (N.Y. Sup. Ct. Aug. 17, 2010)(affirmed by

Merkin and GCC reflexively filed this motion to dismiss proffering arguments that have no merit. Plaintiffs have adequately pled every element of their 10(b) claims against Merkin and GCC. As detailed in the TAC, Merkin affirmatively misrepresented material facts and omitted to disclose material facts in written Fund materials. Merkin knew that many of his statements, such as statements regarding his active management of the Funds, the investment strategy he was utilizing and his due diligence and monitoring of third-party advisors, were false. Merkin further ignored glaring red flags, including suspicions voiced directly to him regarding Madoff, that should have prompted him to investigate. Taken as a whole, these allegations raise a strong inference of scienter sufficient to defeat all Defendants' motions to dismiss Plaintiffs' 10(b) claims. *See* Point II, *infra*.

Defendants' attempts to have Plaintiffs' other claims dismissed are equally unavailing. Plaintiffs have adequately pled all state law claims alleged in the TAC, including claims for common law fraud, breach of fiduciary duty, gross negligence, unjust enrichment and negligent misrepresentation. *See* Point III.C.-H., *infra*. Similarly, Plaintiffs' state law claims are not preempted. *See* Point III.A.-B., *infra*. Thus, for the reasons stated herein, and in the accompanying opposition to the motions filed by the BDO Defendants, the Court should deny all motions to dismiss the TAC in their entirety.

STATEMENT OF FACTS

Plaintiffs And The Funds

The Funds are not named as defendants in this action. Ascot is a Delaware limited partnership formed as a private investment partnership for the benefit of U.S. taxable investors

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Judge Richard B. Lowe III.) (*Id.* Ex. 2); and *In re Arbitration between Sandalwood Debt Fund A LP, et al. v. Merkin*, No. 651441/2010 (N.Y. Sup. Ct.). The findings of the arbitrators cannot be relitigated. *See, e.g., Park Lane Hosiery Co. v. Shore*, 439 U.S. 322, 332-33 (1979).

and certain tax-exempt U.S. persons, such as ERISA plans. ¶32. Merkin has testified that, from the outset, "substantially all" of the assets of the Ascot Fund were tendered to Madoff. ¶49. Investors in the Ascot Fund are limited partners of Ascot Partnership. ¶50. Lead Plaintiff NYLS invested $3 million by purchasing a limited partnership interest in the Ascot Fund in 2006 and continues to own that investment which is now virtually worthless. ¶20.

The Gabriel Fund is also a Delaware limited partnership formed to operate as a private investment partnership for the benefit of U.S. taxable investors. ¶33. Investors in the Gabriel Fund are limited partners of the Gabriel Partnership. ¶79. Lead Plaintiff Berrie invested $500,000 by purchasing a limited partnership interest in the Gabriel Fund and continues to hold that investment. ¶21.

The Ariel Fund is an off-shore hedge fund that is a Cayman Islands corporation. ¶34. Ariel was formed to undertake business as a corporate open-ended investment fund and is considered to be the "offshore twin" of Gabriel. ¶78. Shareholders in the Ariel Fund must be non-U.S. persons or U.S. persons subject to ERISA, or otherwise exempt from paying federal income tax. ¶34. Investors in the Ariel Fund are purchasers of redeemable participating preference shares. Lead Plaintiff Finkelstein IRA, a U.S. resident, invested $500,000 and Plaintiff Nephrology Associates PC Pension Plan, a U.S. resident, invested over $1 million in the Ariel Fund by purchasing redeemable participating preference shares. ¶¶22-23.

Defendant Merkin And GCC

Defendant Merkin is the founder, General Partner and Manager of both the Ascot Fund and the Gabriel Fund. GCC is a Delaware corporation which, along with Merkin, is headquartered at 450 Park Avenue in New York City. Merkin is also the sole shareholder and sole director of GCC which, in turn, is the Investment Advisor to the Ariel Fund. Merkin has

testified that he had "ultimate responsibility for the management, operations and investment decisions" made on behalf of the Funds and had "fiduciary responsibilities" with respect to oversight of Fund assets. ¶¶51, 80.

The Madoff Ponzi Scheme

The details of the Madoff Ponzi scheme are well-known at this point. On December 10, 2008, Madoff confessed to running the largest Ponzi scheme in history. ¶37. On December 11, 2008, the SEC charged Madoff and BMIS with securities fraud. ¶38. Also on December 11, 2008, Madoff and BMIS were criminally charged by the United States Attorneys' Office of the Southern District of New York (the "NYAG"). ¶39. On June 29, 2009, Madoff was sentenced to 150 years in prison. ¶44. Several months later, in November 2009, BMIS's auditor, David Friehling of the firm Friehling & Horowitz, CPAs, P.C., pled guilty to securities fraud. ¶43.

In the late 1980s, Defendant Merkin began running his own investment funds which he marketed to individuals and to charities. ¶47. Sometime in the very early 1990s, Merkin met Madoff and they started doing business together. Thereafter, Merkin started raising large sums of money from investors, including Lead Plaintiffs and other investors in the Funds, who were unaware that their investments were being fed to Madoff, as they were told by Merkin, as detailed below, that their investments were being managed by him pursuant to stated investment strategies and were being invested in a diverse portfolio of securities. Unbeknownst to Lead Plaintiffs and other investors in the Funds, at the time that the Madoff fraud was revealed, Merkin and GCC had entrusted virtually all of the investment capital of the Ascot Fund and at least 25% of the investment capital of the Gabriel Fund and the Ariel Fund to Madoff. ¶38.

Fund Documents Were False And Misleading

Throughout the Class Period, Merkin and GCC disseminated written materials to investors that were false and misleading in a variety of respects. The false and misleading statements and the facts rendering each of them false and misleading are described in detail in the TAC. *See* ¶¶53-59 (Ascot Offering Memoranda); ¶¶70-77 (Ascot quarterly reports and presentations); ¶¶89-95 (Gabriel Offering Memorandum); ¶¶96-109 (Ariel Prospectuses and Confidential Offering Memorandum); ¶¶110-120 (Gabriel and Ariel quarterly reports and presentations).

The misrepresentations made by Merkin and GCC in these written materials revolved around several major themes. First, Merkin routinely represented that he was actively involved in the management of the Funds. The Confidential Offering Memoranda for each of the Funds falsely stated that Merkin, either directly or through GCC, was involved in the management of each of the Funds on a day-to-day and transaction-by-transaction basis and that the success of the Funds depended on Merkin's abilities as a money manager. Merkin led investors in each of the Funds to believe that it was Merkin himself, not a third party, who was actively managing their investments when, in truth, Merkin did little other than ministerial bookkeeping tasks. ¶¶55-60, 90-91, 100-102.

The second common misrepresentation that appeared in the various Fund documents described in detail in the TAC was that Merkin was actively managing Fund investments with a very specific strategy. ¶¶61 (Ascot); 92 (Gabriel); 103 (Ariel). Specifically, for example, Merkin falsely represented that the Ascot Fund was investing in a "diverse portfolio of securities"; was engaging primarily "in the practice of index arbitrage"; was following "a strategy in which the [Ascot] Partnership purchases a portfolio of large-cap U.S. equities drawn

from the S&P 100"; and was making investments through "third-party managers using managed accounts." ¶62. Similar statements perpetuating the illusion that Merkin was actively managing the Funds' assets were made to investors in both Gabriel and Ariel. ¶¶92 (Gabriel); 103-04 (Ariel). For example, Merkin falsely represented that he was investing the assets of Gabriel and Ariel in a "diverse portfolio of securities" and was employing a wide array of investment strategies to decrease the risk of over-concentration. The false perception regarding the specific investment strategies purportedly being utilized by Merkin and GCC in managing the assets of the Funds was bolstered further by the inclusion of risk disclosures in the various Fund documents that, in reality, had nothing to do with the Funds' actual trading strategy. ¶¶64 (Ascot); 94 (Gabriel); 107 (Ariel).

The third area of consistent misrepresentations across the written documents disseminated by Merkin and GCC concerns Merkin's and GCC's delegation of all or a portion of each Fund's assets to multiple independent money managers. Merkin specifically represented to investors in the Funds that he would exercise reasonable care in selecting independent money managers, that he would monitor the results of those money managers, and that limits would be placed on the percentage of Fund assets that could be invested in a single investment. ¶¶67 (Ascot); 93, 95 (Gabriel); 106, 108 (Ariel). These statements were false and misleading because Merkin never exercised any care in delegating investment discretion over all or a significant portion of Fund assets to Merkin and never monitored his results in any meaningful way. ¶¶67, 95, 98, 108. Further, unbeknownst to Ascot investors, all of the Ascot Partnership's assets had been entrusted to Madoff. ¶¶67-68. Similarly, despite Merkin's promises of diversification, between 2002 and 2008, between 80% and 95% of the assets of the Gabriel and Ariel Funds

were managed by just three outside money managers, with at least 25% being turned over to Madoff. ¶¶85, 93, 95, 106.

Merkin And GCC Ignored Glaring Red Flags

Given the level of control that Merkin ceded to Madoff over the assets of the three Funds, Merkin and GCC failed to conduct proper due diligence and blatantly disregarded known red flags that should have alerted them to the fact that the results reported by Madoff and his entire operation were suspect and that the investments required further due diligence. Despite the representations detailed above and in the TAC that they had established due diligence procedures for all fund managers with whom they invested client assets, Merkin and GCC failed to perform even the minimal level of due diligence regarding Madoff and BMIS. ¶¶121-122. The TAC sets out in detail the many red flags that Merkin and GCC failed to investigate or uncover or blatantly disregarded, including the following:

- The description of Madoff's split-strike strategy was inconsistent with the pattern of returns in the track record, which showed only seven small monthly losses in a 14 year period despite market fluctuations.

- Account statements revealed a pattern of purchases at or close to daily lows and sales at or close to daily highs, which is virtually impossible to achieve with the consistency reflected in the documents.

- The volume of options contracts that Madoff would have had to trade did not show up on any of the options exchanges.

- BMIS liquidated its securities positions at the end of each quarter, presumably to avoid reporting large securities positions.

- Madoff's auditor, F&H, had three employees, a 78 year-old living in Florida, a secretary and a 47 year-old accountant. This operation could never audit the scale and scope of Madoff's activities.

- BMIS audit reports showed no evidence of customer activity whatsoever, with neither accounts payable nor accounts receivable from customers

- Trade records often did not match market prices. Confirmation slips often did not reflect prices in the daily ranges and reflected weekend settlement dates.

- Madoff initiated trades in the accounts, executed the trades and custodied and administered the assets through discretionary brokerage agreements, a clear conflict of interest

- Madoff operated under a veil of secrecy and he did not allow outside performance audits by investors.

- Key positions at BMIS were held by members of Madoff's family. Only Madoff's family was privy to his investment strategy.

- Investors had no electronic real-time access to their accounts at Madoff which is traditional for almost all brokerage accounts.

- Madoff settled for charging undisclosed commissions on all of the trades done in investors' accounts rather than collecting larger standard hedge fund fees.

¶125 (additional detail in TAC). Merkin admitted in testimony before the NYAG that he was aware of a number of people who were suspicious of the returns Madoff claimed to achieve, stating that "[t]here were over time persons who expressed skepticism about one or another aspect of the Madoff strategy or the Madoff return." ¶126. Moreover, according to the NYAG Complaint and recently filed summary judgment papers (*see* footnote 8), at least two of Merkin's most trusted colleagues repeatedly told Merkin that Madoff's returns were too good to be true – one warning that it could be a Ponzi scheme. *Id.*

Others took note of these red flags while Merkin, in contrast, blindly continued to funnel money to Madoff and to collect his exorbitant fess for doing so. ¶127. For example, in 1999, Harry Markopolos, wrote a letter to the SEC which stated that: "Madoff Securities is the world's largest Ponzi Scheme."[2] Markopolos, who years ago worked for a rival firm, researched

[2] In 2005, Harry Markopolos wrote another letter to the SEC detailing numerous red flags which indicated that Madoff's fund was a fraud. In the November 7, 2005 letter entitled "The World's Largest Hedge Fund is a Fraud", based on the same information that was available to Defendants herein, Markopolos concluded that Madoff's operation was a fraud and identified 29 "red flags" to prove it. ¶¶139-141.

Madoff's stock-options strategy and, based upon publicly available information, demonstrated that the results were phony.[3]

In addition, Merkin, to a greater extent than many of Madoff's direct investors, had personal knowledge of the many warning signs of fraud including the use of paper trade confirmations sent to investors by mail, Madoff's strict secrecy about money management, the conversion of all holdings to Treasuries at the end of each quarter to reduce transparency, the unusual long-term stability of Madoff's alleged returns, the identity of Madoff's accounting firm that could not possibly conduct a proper audit of Madoff's $50 billion trading operation with thousands of customer accounts, and the fact that Madoff was self-clearing. Merkin also knew that Madoff charged no fees of any kind for his money management services and that Madoff claimed that his only compensation was the normal commissions generated by his trades, commissions that he could have earned if his clients directed the trading themselves. Merkin, who himself charged the standard hefty management and incentive fees for the money he purported to manage, should have recognized that Madoff's willingness to do something for nothing was suspicious. ¶¶133-134.

Merkin and GCC would have steered clear of Madoff had they conducted any due diligence at all. In a January 15, 2009 article entitled "Madoff Might not Have Made Any Trades," the *Boston Globe* reported that, on many client account statements (to which Merkin and GCC had access but Plaintiffs did not), Madoff reported making trades that were worth more than the entire amount the clients had invested with Madoff. The same article revealed that Madoff had reported investments in Fidelity's Spartan US Treasury Money Market fund – a fund which did not exist. ¶144. Many managers of hedge funds of funds, investment advisors,

[3] Markopolos was not alone in questioning Madoff's operations. Others in the investment community understood that his business was suspect and could be a fraud. *See* ¶¶129-131, 135-138, 145-148.

investment banks, and pension funds, who, unlike Merkin and GCC here, took the time and effort to conduct proper due diligence reviews, chose ***not*** to invest with Madoff or any of his affiliated funds as a result of these very same warning signs.[4] Merkin and GCC failed to conduct the due diligence review they represented they were doing, which, if conducted, would have alerted them to Madoff's fraudulent scheme. ¶149.

Merkin Is Unjustly Enriched Through The Payment Of Hundreds Of Millions In Management And Incentive Fees

Merkin and GCC received both management and incentive fees from investors in the Funds in return for purported services as manager of the Funds.[5] Despite his representations in offering materials and elsewhere, Merkin did absolutely nothing to earn these fees as he simply acted as a marketer and a middleman for Madoff whom Merkin failed to adequately oversee, audit, or investigate. ¶161. Merkin collected annual management fees equal to 1% of the capital invested in the Ascot Fund prior to 2002. In 2002, Merkin decided to raise the management fees he received from the Ascot Fund, as of January 1, 2003, from 1% to 1.5% (a difference of $5.3 million per year based on the $1.06 billion under management in 2003). ¶162.[6] Similarly, Merkin's compensation under his agreements with the Gabriel and Ariel Funds included an

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[4] For example, the Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme (the "SEC OIG Report") detailed these investment professionals' due diligence – some of whom, unlike Merkin and GCC here, had access only to publicly available information – and their explanation of why they would not entrust their clients' money to Madoff. The SEC OIG Report concluded that the SEC employees, had they properly examined the red flags and took basic steps to determine if Madoff was operating a Ponzi scheme, would have recognized the significance of the red flags that the investment professionals heeded, and would have discovered the fraud "well before Madoff confessed." The details of the relevant findings in the SEC OIG Report are set out in the Complaint. ¶¶150-155.

[5] On October 20, 2010, the NYAG moved for summary judgment. In its opening brief, the NYAG states that the total fees received for all three Funds for all relevant years was **$728,972,868.85**. *See* Brown Dec. Ex. 3 at 26-27 (emphasis added). The NYAG's motion for summary judgment, filed after discovery, provides additional detail supporting many of Plaintiffs' claims here.

[6] In a letter to investors seeking approval of the increase, Merkin vaguely cited "rising expenses." This misrepresentation perpetuated and reinforced the falsehood that Merkin was doing work related to the management of the Ascot Fund.

annual management fee of 1% of assets under management, and, in addition, an incentive fee of 20% of any profits. The incentive fee Merkin collected included 20% of the profits reported by Madoff, which, of course, were fictitious.

The Merkin Fraud Is Publicly Revealed

On December 11, 2008, Defendant Merkin sent a letter to investors in the Ascot Fund and disclosed for the first time that "substantially all" of the investment assets of the Ascot Fund (approximately $1.8 billion) were managed by Madoff. The letter from Merkin also stated, in part, "[a]t this point, it is impossible to predict what recovery, if any, may be had on these assets." ¶169. One week later, on December 18, 2008, Defendant Merkin sent a follow-up letter to investors in the Ascot Fund and informed them that the Ascot Fund would need to be dissolved. That same day, Defendant Merkin also sent a letter to investors in the Gabriel Fund and disclosed for the first time that the Gabriel Fund had suffered substantial losses "related to the Madoff managed account" and that as a result of the devastating impact on the Gabriel Fund's portfolio that the Gabriel Fund would be dissolved and liquidated. A similar letter was sent by Merkin to Ariel Fund investors on December 18, 2009, and disclosed that Madoff related losses necessitated that he wind down the Ariel Fund and sell off its holdings. ¶170. As a result of the exposure to Madoff, the investors in the Funds have lost approximately $2.4 billion. ¶172. All three Funds have been placed into receivership. ¶177.

ARGUMENT

I. LEGAL STANDARDS ON A MOTION TO DISMISS

When deciding a defendant's motion to dismiss under Fed. R. Civ. P. 12(b)(6), the court "must accept as true all of the factual allegations contained in the complaint", *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 572 (2007) and "draw all inferences in the light most favorable to the nonmoving party[.]" *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 95 (2d Cir. 2007). To

survive a Rule 12(b)(6) motion to dismiss, the allegations in the complaint must meet a standard of "plausibility." *Twombly*, 550 U.S. at 564. A claim is facially plausible "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009).

The Private Securities Litigation Reform Act (the "PSLRA") and Rule 9(b) of the Federal Rules of Civil Procedure impose particularity pleading requirements on Section 10(b) complaints, mandating that plaintiffs "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *One Commc'ns. Corp. v. JP Morgan SBIC LLC*, No. 09-1815-CV, 09-2324-CV, 2010 U.S. App. LEXIS 12386, at *4 (2d Cir. June 17, 2010) (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007)). When assessing compliance with Rule 9(b), the court's inquiry "is not limited to specific paragraphs of the complaint viewed in isolation" – rather, the complaint is "read as a whole." *See First Interregional Advisors Corp. v. Wolff*, 956 F. Supp. 480, 485 (S.D.N.Y. 1997).

The PSLRA requires plaintiffs 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)(A). Under *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, ("*Tellabs I*") 551 U.S. 308 (2007), the deciding court must: 1) accept all factual allegations in the complaint as true; 2) determine "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter", *Id.* at 322-23; and 3) after taking into account "plausible opposing inferences" (meaning "nonculpable explanations for the defendants' conduct, as well as inferences favoring the plaintiff"), the complaint will survive 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 323-24.[7]

II. PLAINTIFFS HAVE ADEQUATELY ALLEGED VIOLATIONS OF SECTION 10(b) AND 20(a)

To state a claim under Section 10(b) and Rule 10b-5 of the Exchange Act, a plaintiff must allege facts sufficient to show that a defendant: (1) in connection with the purchase or sale of securities; (2) made a materially false statement or omitted a material fact; (3) with scienter; and (4) the plaintiff's reliance on the defendant's action (5) caused injury to the plaintiff. *Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC*, 595 F.3d 86, 92 (2d Cir. 2010). Plaintiffs have pled each element of their federal securities fraud claims against Defendants with the requisite particularity, and such claims should be upheld.[8]

A. Plaintiffs Have Alleged Numerous Misrepresentations

Defendants argue that Plaintiffs do not identify any misrepresentation or omission in connection with their decisions to invest in the Funds. Br. 11-14. Defendants' arguments are contradicted by the detailed allegations of the TAC. Plaintiffs have specifically alleged that Defendants expressly misrepresented and failed to disclose material facts concerning: (1) Merkin's non management of the Funds; (2) the Funds' investment strategies, including the

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[7] The inference of scienter need not, however, be "irrefutable, *i.e.*, of the 'smoking-gun' genre, or even the most plausible of competing inferences.'" *Id.* at 324. If the inferences are equally plausible, the complaint should be sustained. In short, a "tie . . . goes to the plaintiff." *Akerman v. Arotech Corp.*, 608 F. Supp. 2d 372, 382 (E.D.N.Y. 2009). The *Tellabs* Court posed the relevant inquiry as being: "when the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" *Tellabs*, 551 U.S. at 325.

[8] To state a claim under Section 20(a) of the Exchange Act, a plaintiff must allege both a primary violation and control over the primary violator. *In re Parmalat Sec. Litig.*, 594 F. Supp. 2d 444, 455-56 (S.D.N.Y. 2009). Defendants do not challenge their control over the Funds for purposes of Section 20(a). They assert that Plaintiffs have not alleged the predicate primary violation. Br. 22-23. Since Plaintiffs have sufficiently pled a primary violation, their control person claims should also be sustained.

diversification of the Funds; and (3) the monitoring and due diligence not being performed by Merkin. ¶¶54-77, 89-120, 121-160.

1. Defendants' Misrepresentations About Merkin's Management Of The Funds

Defendants led class members to believe that it was Merkin, not a third party (*i.e.*, Madoff), who was actively managing their investments. ¶¶54-55, 89-91, 96-97, 100. The Ascot and Gabriel offering memoranda stated that Merkin had "ultimate responsibility for the management, operations and investment decisions made on behalf of the [Ascot/Gabriel] Partnership." (¶¶51, 59, 80) and touted Merkin's purported personal attention to individual trades made on behalf of the Funds. ¶¶59, 91. According to the 2001 Ariel Prospectus, the success of the Ariel Fund depended primarily upon GCC and that Merkin would "retain overall investment responsibility for the portfolio." ¶¶97-98, 100.

Class members also entrusted their money to Merkin because they were told:

- "All decisions with respect to the management of the capital of the [Ascot] Partnership are made exclusively by J. Ezra Merkin. Consequently, the [Ascot] Partnership's success depends to a great degree on the skill and experience of Mr. Merkin." ¶56.

- "The Managing Partner is required to devote substantially his entire time and effort during normal business hours to his money management activities, including (but not limited to) the affairs of the [Ascot] Partnership." ¶57.

- Merkin personally managed the Gabriel Fund's assets on a day-to-day basis and would devote "substantially his entire time and effort during normal business hours to the management of the [Gabriel] Partnership." ¶91.

- The 2001 Ariel Fund Prospectus stated, that, "... The Investment Advisor will retain overall investment responsibility for the portfolio of the Fund....". ¶101.

- Merkin's role was so central to the management of the Funds that the Funds would need to be terminated in the event of his death or incapacity. ¶¶60, 91, 97.

During the Class Period, Defendant Merkin also sent quarterly account statements to Fund investors that were accompanied by written reports from Merkin describing the investment

strategies and performance of the Funds. ¶¶71-77 (Ascot); ¶¶110-120 (Gabriel and Ariel). These quarterly issued statements, signed by Merkin, misleadingly made it appear that Merkin himself was primarily responsible for the investment strategy and decisions made on behalf of the Funds. ¶112.

It is now clear that Defendants' representations concerning Merkin's management of the Funds were false and misleading because Merkin was not the day-to-day manager, and was devoting little if any time to managing the investments of the Funds. Instead, Merkin was blindly feeding all assets invested in the Ascot Fund and a substantial portion of the assets invested in the Gabriel and Ariel Funds directly to Madoff. ¶¶63, 91-92, 104. Merkin's only job consisted of acting as a marketer, doing ministerial bookkeeping and participation in a few monthly conversations with Madoff each year. ¶¶55, 58, 90, 102. Indeed, it was totally contrary to Merkin's self-interest to ask Madoff any hard questions since Merkin's financial success was totally dependent on Madoff's purported results.

Defendants argue that their failure to identify Madoff's role as an investment manager is not material because they had no duty to disclose the identities of the Funds' investment managers. Br. at 13. Defendants' argument misses the point because the substance of Plaintiffs' allegations is not merely that Defendants should expressly have named Madoff as an investment manager of Fund assets, but instead that Defendants failed to disclose Madoff's true role in the management of the Funds assets and misrepresented the role of Merkin himself.[9]

Defendants also argue that they properly disclosed Madoff's involvement with the Ascot Fund because they twice identified Madoff as a "prime broker[ ] and custodian[ ] for the [Ascot]

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[9] *See People v. Merkin,* No. 450879/09, 2010 N.Y. Misc. LEXIS 523, at *10 (N.Y. Sup. Ct. Feb. 8, 2010)(finding material omissions in the Ascot Fund offering memorandum where defendants "fail[ed] to reveal Madoff's actual role, and the actual investment strategy being employed").

Partnership." Br. at 14. But this disclosure itself was also a material misrepresentation.[10] As alleged in the TAC, the Ascot offering memorandum describes Madoff's involvement in the Ascot Fund only as a "principal prime broker," a purely administrative function. ¶¶68-69. These disclosures also created the false impression that the Ascot Fund had established a separation between the entity that cleared trades and kept custody of the securities on the one hand, and the investment managers making investments decisions on the other. There is no disclosure anywhere in documents provided to investors that all Ascot Fund assets had been entrusted to Madoff or that Madoff was making all purported investment decisions for the Ascot Fund.[11]

Defendants' contention that cautionary language that Merkin "***may*** delegate investment discretion...to independent money managers" and "***may*** not have custody over the funds invested with other money managers" warned investors of exactly the risks the Plaintiffs claim were not disclosed is misplaced. Br. at 11-12 (emphasis added).[12] It is well settled that the bespeaks-caution doctrine applies only to statements that are forward-looking and is not applicable to misrepresentations of present or historical facts which cannot be cured by cautionary language. *Iowa Pub. Employees' Ret. Sys. v. MF Global, Ltd.*, No. 09-3919-CV,

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[10] *See Merkin,* 2010 N.Y. Misc. LEXIS 523 at *15-16 (holding that where Merkin "gave Madoff complete control and investment discretion" over significant parts of funds' assets, a reference to Madoff in offering materials as a "prime broker" was a material misrepresentation because such "brokers do not make investment management decisions like Madoff was making.").

[11] Contrary to Defendants' arguments, the losses suffered by Plaintiffs are not the result of Madoff's custodianship over Fund assets, but rather a result of misrepresentations with respect to trading results and fictitious profits.

[12] Defendants' reliance on *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 360 (2d Cir. 2002), *aff'd,* 40 Fed. Appx. 624 (2d Cir. 2002), is unavailing. In that case, the offering memoranda explicitly warned of the same risk complained of by the plaintiffs. *See also Olkey v. Hyperion 1999 Trust Term, Inc.*, 98 F.3d 2, 5-6 (2d Cir. 1996), *cert. denied,* 520 U.S. 1264 (1997) (cautionary language addressed exact risk).

2010 U.S. App. LEXIS 19138 (2d Cir. Sept. 14, 2010).[13] Defendants' purported cautionary language also does not protect them from liability because the bespeaks caution doctrine "does not apply where a defendant knew that its statement was false when made." *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 419 (S.D.N.Y. 2000). Plaintiffs have specifically alleged that Merkin gave Madoff complete control and investment discretion over all of Ascot's and a substantial portion of Gabriel's and Ariel's funds. ¶¶63, 64, 94, 107. Since Merkin delegated all investment discretion to Madoff, a fact Merkin was presently aware of at the time Defendants disseminated the various offering memoranda to the Funds' investors, the bespeaks caution doctrine does not apply. In addition, the "cautionary language" cited by Defendants does not address other misrepresentations and omissions concerning other issues, such as Merkin's failure to exercise judgment in supervising the delegation of investment management to Madoff and his failure to conduct due diligence and to audit Madoff's activities regarding the Funds.[14]

2. Defendants' Misrepresentations About Investment Strategies

Plaintiffs allege that Defendants made false and misleading statements regarding the specific investment strategies utilized by Merkin in purportedly actively managing their investments. ¶¶61, 92, 103. Merkin's decision to hand over all of the Ascot Fund's assets and at least 25% of the Gabriel and Ariel Funds' assets to Madoff was in direct contravention of the

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[13] To protect defendants from liability, purported cautionary language also must be meaningful and directly relevant to the risk being warned about. *Commodity Futures Trading Comm'n v. Commodity Inv. Group, Inc.*, No. 05 Civ. 5741 (HB), 2005 US. Dist. LEXIS 27454 (S.D.N.Y. Nov, 10, 2005) (boilerplate risk language insufficient); *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) (holding that "[c]autionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired").

[14] *Merkin,* 2010 N.Y. Misc. LEXIS 523 at *16 (rejecting Merkin's reliance on cautionary language because "[d]efendants have failed to show that no reasonable investor could have been mislead about the nature of the risk when he or she invested.")

Funds' stated investment strategies that were implemented to ensure diversification and limit risk. Misrepresentations about the nature of investment strategies and goals are actionable under the federal securities laws.[15]

The offering memoranda for the Funds provided investors with detailed information regarding investment strategies and goals, and specifically highlighted Merkin's required responsibilities. For example, Defendants represented to Ascot investors that the Ascot Fund was invested in a "diverse portfolio of securities"; engaged primarily "in the practice of index arbitrage"; followed "a strategy in which the [Ascot] Partnership purchases a portfolio of large-cap U.S. equities drawn from the S&P 100"; and made investments through "third-party managers using managed accounts." ¶¶61-62. Substantially similar representations were made to Gabriel investors, including statements that assets of the Gabriel Fund would be invested in a "diverse portfolio of securities"; that Merkin was engaging primarily "in the practice of index arbitrage"; that funds were generally investing in the distressed debt space and in the "securities of corporations believed to be fundamentally undervalued"; and the Merkin was making investments through "third-party managers" engaging "in similar investment strategies" as the Gabriel Fund. ¶62. Defendants told Ariel Fund investors that GCC, through Merkin, was actively managing their investments with a very specific strategy of "investing and trading in marketable securities and instruments of companies or other entities which are the subject of a Reorganization"; and that the securities and other instruments in which the Ariel Fund would invest would also include "common stock, preferred stock and other evidences of ownership

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[15] *See Merkin,* 2010 N.Y. Misc. LEXIS 523 at *16-17 (holding that with regard to Ariel and Gabriel, Merkin's misrepresentations regarding investment strategy of investing in distressed businesses, referred to a false historical fact); *In re Ashanti Goldfields Sec. Litig.*, 184 F. Supp. 2d 247, 252-55 (E.D.N.Y. 2002) (statements to plaintiffs that defendants' company used hedging as an investment strategy to minimize risk were actionable where plaintiffs alleged that the company, in fact, used hedging in a risky and speculative manner).

interest; bonds, trade creditor claims and other evidences of indebtedness and put and call options on securities", "mutual funds, private investment partnerships, closed end funds and other pooled investment vehicles", and "restricted securities." ¶103. Many of the quarterly reports disseminated to Gabriel Fund and Ariel Fund investors also represented that the Gabriel and Ariel Funds were investing in businesses that were distressed, involved with reorganizations or involved with merger arbitrage. ¶¶113-118. Merkin also made presentation pitches to potential investors in which he described the Ascot Fund as having "Actively Managed Strategies." ¶73.

These statements about investment strategies for the Funds were complete falsehoods – investors' assets simply were being funneled to Madoff. Further, none of the purported strategies could actually be achieved by investing the Funds' assets with Madoff who purported to employ, in whole or in part, a "split-strike conversion strategy." ¶¶46, 64, 125.[16]

Defendants' false and misleading statements about investment strategies and objectives also included critical misrepresentations about the diversification of assets in the Funds. As alleged in the TAC, the 2006 Ascot Offering Memorandum and 2006 Gabriel Offering Memorandum both stated, that "The [Ascot/Gabriel] Partnership's investment objective is to provide limited partners with a total return on their investment consisting of capital appreciation and income by investing in a ***diverse portfolio of securities***." (emphasis added). ¶¶61, 92. Similarly, the 2006 Ariel Offering Memorandum represented that the Fund would engage in a number of strategies, including trading in the securities of companies in reorganization, buying

[16] Defendants' argument that the offering memoranda accurately "disclosed that the Funds would engage in the type of investment strategies that Madoff purported to be conducting" (Br. at 9, 11) is misleading. Plaintiffs' claim is that Defendants knew that these purported investment objectives could not be achieved through that strategy. Moreover, although the 2006 Ascot Offering Memorandum described a strategy that was similar to the one that Madoff was purportedly following (¶61), this was also a misrepresentation, because 100% of Ascot's assets were concentrated in one investment with Madoff, and the Ascot strategy was actually Madoff's "split-strike" strategy disguised as Ascot's own.

undervalued and short selling overvalued securities, making indirect investments in mutual funds and other pooled investment vehicles, and specifically stated that no more than 25% of the Fund's assets would be in a single investment. ¶103. These representations to investors were completely false as Merkin never had a diversification strategy -- he had given a single third-party manager, Madoff, complete and total management responsibility and discretion over the Ascot Fund and over at least 25% of the Gabriel and Ariel Funds.

Investors were also led to believe that Merkin was actively pursuing a specific diversification strategy for the Funds by using multiple third-party managers with varying execution strategies, thereby avoiding the risk of concentrating capital in too few investments or managers. For example, in the 2006 Ascot Offering Memorandum, under the heading "Risk Factors" and subheading "Independent Money Managers," Defendant Merkin disclosed that he had authority to delegate investment discretion for all or a portion of the Ascot Fund's assets to multiple independent money managers. ¶67. This representation misleadingly created the impression that the Ascot Fund's assets would be diversified through a number of vehicles and managers – an outright misrepresentation given that 100% of Ascot's assets were actually managed by one manager, Madoff.

Similarly, as to the Gabriel and Ariel Funds, Plaintiffs allege that both of their offering memoranda indicated that their assets would be invested in a number of different investment vehicles. In the 2006 Gabriel Offering Memorandum, Defendant Merkin disclosed that he had authority to delegate investment discretion for all or a portion of the Gabriel Fund's assets to multiple independent money managers. ¶95. The statements in the 2006 Gabriel Offering Memorandum that the General Partner "will not permit more than the greater of 50% of the Partnership's capital and 25% of the Partnership's total assets to be invested in a single

investment", that "it will not permit more than 10% of the Partnership's capital to be placed at risk in a single investment" and that "the General Partner will have discretion to determine how much is at risk for purposes of this test" falsely created the impression that the Gabriel Fund's assets were fully diversified, when in truth Merkin was handing over at least 25% to on single investment, Madoff. ¶93. These exact statements appeared in the 2006 Ariel Offering Memorandum and created the same false impression. ¶¶106-108.

The TAC also describes misrepresentations in the quarterly and annual account statements that Merkin and GCC sent out to members of the Class. ¶¶70, 110. These quarterly statements usually were accompanied by a written report by Merkin describing the investment strategies and performance of the Funds. The quarterly reports were misleading because they gave the false impression that Merkin and his staff were directly managing the assets of the Funds and that Fund assets were being invested in specific types of securities. ¶111.[17]

3. Misrepresentations By Defendants Concerning Due Diligence And Monitoring Of Investment Managers

As the principal manager for the Funds, Merkin had an obligation to perform due diligence on, and monitor the performance of, all outside money managers to whom he entrusted the Funds' assets. The TAC specifically identifies misrepresentations and omissions made by

[17] Defendants' argument that Section 10(b) claims cannot be based on quarterly letters and post-investment representations because they were issued after the Plaintiffs' decisions to invest in the Fund (Br. at 13, fn.6) misses the mark. *See U.S. v. Kelley*, 551 F.3d 171, 175-76 (2d Cir. 2009), *cert. denied*, 129 S. Ct. 2756 (2009). In *Kelley*, the defendant contended that because bogus account statements were created and disseminated two to four years after the purchases of the underlying securities, they were not made in connection with the sale or purchase of a security as required for a section 10(b) violation. The court found that "[t]he section 10(b) violations that were charged stem not from the bogus account statements themselves ... but instead stem from [the defendant's] larger schemes to induce his clients' to purchase the securities or to use his clients' funds to purchase the securities ... [r]eferences to the bogus statements were admitted as evidence because they tended to demonstrate [the defendant's] intent to defraud his clients and the scope of the schemes he employed." *Id.* at 175. *See also S.E.C. v. Holschuh*, 694 F.2d 130, 143-44 (7th Cir. 1982) ("[A] scheme to defraud may well include later efforts to avoid detection of the fraud."). Moreover, in many cases, class members made further investments in the Funds in reliance on these quarterly statements as well.

Defendants regarding their monitoring of outside investment managers they selected. For example, in all of the offering memoranda, Merkin assured investors that he would ***"exercise reasonable care"*** in selecting independent money managers and would ***"monitor the results of those money managers."*** ¶¶67, 95, 108. To the detriment of investors, Merkin's promises that he would monitor investment managers simply were not true.

The TAC identifies facts establishing that Defendants knew that their statements concerning their monitoring of investment managers, such as Madoff, were materially false. *See Anwar v. Fairfield Greenwich Ltd.* ("*Anwar II*"), No. 09 Civ. 0118 (VM), 2010 U.S. Dist. LEXIS 86716, at *78 (S.D.N.Y. Aug. 18, 2010) (holding that the Madoff feeder funds there "failed to check information that they had a duty to monitor" which were based on allegations of "red flags" that were either within the defendants' knowledge or that they seemingly failed to learn). Indeed, Merkin clearly failed to check information that he was required to monitor. ¶¶127-132; 135-155. For example, Merkin should have taken some type of action in light of articles questioning the consistency of Madoff's returns, Madoff's insistence on secrecy and the inability of "more than a dozen hedge fund professionals, including current and former Madoff traders" to duplicate Madoff's returns using his strategy. ¶¶130-32. If Defendants had taken their due diligence representation seriously, as had been promised in the Funds' offering materials, they would have at least reviewed trading confirmations and account statements that indicated that it was virtually impossible to achieve with consistency any of Madoff's results.

B. Plaintiffs Have Properly Pled Scienter

1. Applicable Standards

Scienter can be pled either by (a) alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (b) alleging facts to show that defendants had both motive and opportunity to commit fraud. *ATSI Commc'ns*, 493 F.3d at 99 (citing

Ganino v. Citizens Utils. Co., 228 F.3d 154, 168-69 (2d Cir. 2000); *see also Novak v. Kasaks,* 216 F.3d 300, 310 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000).

> At least four circumstances may give rise to a strong inference of the requisite scienter: where the complaint sufficiently alleges that the defendants (1) "benefited in a concrete and personal way from the purported fraud"; (2) "engaged in deliberately illegal behavior"; (3) "knew facts or had access to information suggesting that their public statements were not accurate"; or (4) "failed to check information they had a duty to monitor."

ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187, 199 (2d Cir. 2009) (quoting *Novak*, 216 F.3d at 311).

Recklessness is defined as "'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *ECA*, 553 F.3d at 198 (quoting *Novak,* 216 F.3d at 308). A strong inference of recklessness may arise where plaintiffs point to "facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud." *Novak*, 216 F.3d at 308. Courts have stressed that:

> [s]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements. Under such circumstances, defendants *knew* or, more importantly, *should have known* that they were misrepresenting material facts related to the corporation.

In re Globalstar Sec. Litig., No. 01 Civ. 1748 (SHS), 2003 U.S. Dist. LEXIS 22496, at *17 (S.D.N.Y. Dec. 12, 2003) (citing *Novak*, 216 F.3d at 308); *In re Nortel Networks Corp. Sec. Litig.*, 238 F. Supp. 2d 613, 631 (S.D.N.Y. 2003)(emphasis added).

2. Plaintiffs' Claims Satisfy The Scienter Requirement

Plaintiffs have sufficiently alleged scienter by showing that Defendants actually knew that their public statements were false. With respect to the bulk of the statements at issue – *i.e.*, statements regarding management, investment strategies and due diligence – Merkin had actual