knowledge of their falsity. Merkin obviously knew what he was and was not doing at the time he disseminated these statements. Plaintiffs also have alleged that Defendants, but for their extreme recklessness, should have known that their public statements were false because of glaring red flags and obvious signs of fraud to which they turned a blind eye. In other words, Defendants "failed to check information they had a duty to monitor." *ECA*, 553 F.3d at 199 (quoting *Novak*, 216 F.3d at 311; *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008)). Plaintiffs have also independently alleged scienter by pleading facts indicating that Merkin had both motive and opportunity, *e.g.*, that he "benefited in a concrete and personal way from the purported fraud." *ECA*, 553 F.3d at 199 (quoting *Novak*, 216 F.3d at 311; *Teamsters Local*, 531 F.3d at 194).

a. Defendants Ignored Numerous "Red Flags" And Failed To Check Information They Had A Duty to Monitor

Plaintiffs list a multitude of red flags of which Defendants were actually aware that contradicted their public statements to investors. ¶¶ 125; 133-142. At the very least, given the level of control over the Funds that Merkin ceded to Madoff, Merkin's and GCC's failure to conduct proper due diligence and blatant disregard of their obligation to monitor Madoff in light of the various known red flags are sufficient to plead and establish recklessness. *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996) ("An egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of recklessness."). Merkin and GCC had access to information, as described in the TAC, yet both either failed to review or check information they had a duty to monitor or simply chose to ignore obvious signs of fraud.

Significantly, Merkin admitted in sworn testimony that he was aware of a number of people who were suspicious of the returns Madoff claimed to achieve. ¶126. In fact, 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.* Merkin also received a copy of the May 2001 Barron's and MAR/Hedge articles discussing the belief of many hedge fund professionals and market strategists that Madoff could not possible achieve the returns he reported under his investment strategies. ¶132. Seven years later, Merkin still had copies of both of these articles in his files. *Id.* In addition, Merkin, had personal knowledge of the many warning signs of Madoff's fraud. ¶133.

At a minimum, these red flags (described in the TAC and herein) put Defendants on notice of risks that they purposely ignored. *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *79 (red flags concerning "Madoff's secret operations", the fact that Madoff's "multi-billion operation [was] run by a small circle of family members" and Madoff's refusal to answer questions about his trading strategy "would put any reasonable corporate executive or fiduciary or diligent professional on high alert that something big was terribly wrong."). Instead, Defendants recklessly turned a "blind eye" to all indications of problems that Defendants knew they had a obligation to investigate. *Makor Issues & Rights, Ltd. v. Tellabs Inc.* ("*Tellabs II*"), 513 F.3d 702, 704 (7th Cir. 2008) ("When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk."). By describing these red flags in detail, the TAC adequately alleges scienter.[18]

Defendants have failed to establish, as required under *Tellabs I*, any plausible competing inference sufficient to defeat the strong inference of scienter established by the facts laid out in the TAC. *See Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *84 (finding that "any competing

[18] *In re Comverse Tech. Inc. Sec. Litig.*, 543 F. Supp. 2d 134, 142-45 (E.D.N.Y. 2008) (finding scienter where it was alleged that the red flags were "so obvious that [defendants] must have been aware" of the alleged fraud); *In re Scottish Re Group Sec. Litig.*, 524 F. Supp. 2d 370 (S.D.N.Y. 2007); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 649 (S.D.N.Y. 2007); *Bruhl v. Price Waterhousecoopers Int'l*, No. 03-23044-Civ-Marra, 2007 U.S. Dist. LEXIS 21955 (S.D. Fla. Mar. 27, 2007) (repeated red flags inconsistent with investment strategy pleads strong inference of severe recklessness).

inference of innocent conduct – e.g., that the [defendants] were bamboozled by Madoff -- is not as compelling as the finding of scienter. To discount Plaintiffs' allegations at this stage would be to wave away the [defendants'] exposure lasting almost two decades of red flags..."). The failure of Defendants to put forth a plausible competing inference of scienter is underscored by the two arbitration decisions against Merkin premised on the same set of facts giving rise to the TAC here. *See* Footnote 2, *supra*. The arbitrators' findings show that, at least at the pleading stage, a finding of scienter is at least as plausible as any other scenario.

Defendants incorrectly argue that the most reasonable inference from the facts alleged is that they themselves were deceived by Madoff, just like the SEC and others in the investing community and as a result "additional due diligence...would not have led them to uncover Madoff's Ponzi scheme." Br. at 17-18.[19] Defendants rely on *South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009), a case where the Second Circuit upheld the dismissal of claims by an investor against defendant Hennessee Group ("HG"), a third-party advisor that had recommended investments in Bayou, a hedge fund that turned out to be a fraud. Unlike the situation here, HG was not the actual manager of a feeder fund in which the plaintiff had invested funds but, instead, was a hedge fund consulting firm, more akin to a retail broker making stock recommendations. HG had made no written representations concerning any monitoring responsibilities to the South Cherry investors concerning their investment in the Bayou hedge fund.

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[19] The SEC's conduct and lack of action against Madoff for many years does not exonerate Defendants, nor is it dispositive of their scienter. Indeed, the very language of the Exchange Act states that "[n]o action or failure to act by the [SEC] . . . in the administration of this title shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act . . . be deemed a finding by such authority that such statement or report is true and accurate on its face or that it is not false or misleading." 15 U.S.C. § 78z. *See also Dichter-Mad Family Partners, LLP v. United States*, 707 F. Supp. 2d 1016 (C.D. Cal.) (finding that the conduct of an SEC examination and whether the agency takes any action at all is at the SEC's discretion).

The *South Cherry* case was dismissed, on these very specific facts, because the Court found that the inference that the third-party advisor recklessly failed to conduct due diligence was weaker than the inference that due diligence would not have uncovered the Bayou's carefully concealed fraud. 573 F. Supp. 3d 98. Here, the exact opposite is true because Defendants were privy to an inordinate number of red flags that should have placed them on notice of the fraud and, more importantly, due diligence efforts by other financial professionals ***actually did*** uncover gross inconsistencies in Madoff's strategies and operations. ¶¶129-131, 135-155. Anyone in the position of Defendants here, who had access to a "continuous stream of incoming red flag information," should have been able to determine that Madoff's returns were not achievable and that he was a fraud. *See e.g.* ¶154 (quoting the SEC OIG Report interview of a CEO of a research firm stating that "The returns [by Madoff] were impossible. Absolutely impossible in my opinion. No financial strategy could produce those sort of returns.") Thus, unlike in *South Cherry*, it cannot be said that "due diligence would not have uncovered the fraud." *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 418 (S.D.N.Y. 2007).

The *Anwar II* Court expressly distinguished *South Cherry* because the defendants in *Anwar II* "had a continuous stream of incoming red flag information . . ., in contrast to the information that Hennessee Group was alleged it should have affirmatively sought out." 2010 U.S. Dist. LEXIS 86716, at *87. The Court also stated that:

> [t]he key difference between this case and *South Cherry* is that the defendant in South Cherry failed to learn what it would have if, with affirmative steps and more diligence, it had done more to inform itself. Here, Plaintiffs allege that the [defendants] ignored not only what was handed to them but that what they were given was readily suspicious to any reasonable person exercising ordinary prudence. When presented with notorious signs of fraud, they discounted them and were unwilling to recognize what other similarly situated financial firms were able to do with the same information to protect their investors from a massive Ponzi scheme...A fair inference that flows from the facts alleged is that if they

failed to see the perceptible signs of fraud, it may have been because they chose to wear blinders."

Id. at *87-88.[20]

b. Allegations Of Motive And Opportunity

Scienter can also be pled by alleging that defendants had both motive and opportunity to commit the fraud at issue. "Motive. . . entail[s] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged." *Novak*, 216

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[20] Defendants' other citations are also inapposite. *See* Br. 18-19. *Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, No. 09 Civ. 3708 (TPG), 2010 U.S. Dist. LEXIS 32215 (S.D.N.Y. Mar. 31, 2010), and *In re Tremont Securities Law, State Law & Insurance Litigation*, No. 09 md 2052, Master File No. 08 Civ. 11117 (TPG), 2010 U.S. Dist. LEXIS 32216 (S.D.N.Y. Mar. 30, 2010) each address duties of auditors. Defendants also ineffectively rely on *General Electric Co.*, 101 F.3d 263. In *Chill*, plaintiffs supported scienter allegations by claiming deliberate blindness on the part of GE with respect to the financial records of its ***third-tier subsidiary***. *Id.* at 270. In holding that plaintiffs had not adequately alleged scienter, the court reasoned that there was no evidence that GE would normally expect to see anything further than profits from its third-tier subsidiaries. *Id.* Therefore, GE was not faced with sufficient information to suggest that its failure to further investigate the trading practices of one of its subsidiaries constitutes recklessness. *Shields v. Citytrust Bankcorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994), and *Hart v. Internet Wire, Inc.*, 50 Fed. Appx. 464 (2d Cir. 2002), are also easily distinguishable because in those cases plaintiffs failed to allege facts that would have actually put defendants on notice of the fraud. In contrast, Merkin is the exact person who made the decision to invest the Funds assets with Madoff and was on notice of red flags that Madoff was a fraud. *Securities and Exchange Commission v. Cohmad Securities Corp.*, No. 09 Civ. 5680 (LLS), 2010 U.S. Dist. LEXIS 8597 (S.D.N.Y. Feb. 2, 2010) and *MLSMK Investments Co. v. JP Morgan Chase & Co.*, No. 09 Civ. 4049 (BSJ), 2010 U.S. Dist. LEXIS 85466 (S.D.N.Y. July 14, 2010), are also both distinguishable. As in *South Cherry*, defendant Cohmad was not a "feeder fund," but only directed potential clients to Madoff. Unlike here, Cohmad had no contact with the investors, did not have offering materials, and had no responsibilities whatsoever, written or oral, to conduct due diligence, monitor or oversee investments with Madoff. 2010 U.S. Dist. LEXIS 8597, at *6-10. In *MLSMK Invs. Co.*, the plaintiff brought suit against JP Morgan Chase & Co. ("JPMC") and JP Morgan Chase Bank, NA ("Chase Bank") where Madoff held an account registered to BMIS for at least sixteen years. 2010 U.S. Dist. LEXIS 85466, at *2. Unlike in this case, the Court determined that plaintiff had not alleged any facts indicating that JP Morgan owed a duty of care to plaintiff. *Id.* at *19-21 (holding that "Plaintiff has utterly failed to plead any reason to impose on Defendant JPMC a duty to third-party non-customers whose funds Madoff caused to be deposited in an account at Defendant Chase Bank.'").

F.3d at 307. The exorbitant and unique fees and commissions that the Defendants were able to obtain by investing the Funds' assets with Madoff provide the motive to commit fraud.[21]

Defendants argue that Merkin's compensation of hundreds of millions of dollars is insufficient to satisfy the "motive and opportunity" test. Br. 15-16. In so arguing, Defendants rely on cases supporting the general view in this Circuit that financial incentives possessed by all executives and hedge fund managers do not constitute motive and opportunity. But the facts alleged in the TAC do not compare with the garden variety motive allegations made by the plaintiffs in *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Edison Fund v. Cogent Investment Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 227 (S.D.N.Y. 2008) and *Vogel v. Sands Brothers & Co.*, 126 F. Supp. 2d 730, 739 (S.D.N.Y. 2001). Here, Merkin had more than the incentive of a typical executive to avoid asking questions about Madoff's strategies. For his purported "management" of the Funds, Merkin pocketed ***more than one-half billion dollars*** in fees from investors in the Funds. ¶¶15-16, 163-164. Accordingly, Plaintiffs have adequately pled a strong motive that benefited Defendants in a "concrete and personal way." *Novak*, 216 F.3d at 307-08.

Merkin attempts to refute an inference of motive by claiming that he invested his own money with Madoff and therefore did not know about Madoff's Ponzi scheme. Br. 16-17. However, this argument fails because Plaintiffs are not required to show that Merkin actually knew of the Ponzi scheme to have had the requisite scienter. Plaintiffs allege that Merkin

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[21] Courts have recognized that allegations of unusually large fees are sufficient to plead motive. *See. e.g. Allied Irish Banks, P.L.C. v. Bank of Am., N.A.*, No. 03 Civ. 3748 (DAB), 2006 U.S. Dist. LEXIS 4270 (S.D.N.Y. Jan. 31, 2006) ("unusually large" fees and "exorbitant" interest sufficed to plead motive); *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 446 F. Supp. 2d 163, 187 (S.D.N.Y. 2006) ("Unlike a motive to increase stock prices, shared by all corporate insiders, a motive to generate increased fees . . . would be 'a concrete and personal benefit to the individual defendants resulting from the fraud.'"); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 344-46 (S.D.N.Y. 2004) (motive allegations sufficient where the auditor was paid consulting fees of six times its auditing fees).

misrepresented numerous facts about the Funds and their strategies, failed to monitor third party managers such as Madoff as represented in the various offering materials, and that he recklessly ignored red flags that caused other investment professionals not to invest with Madoff, and at the same time collected hefty fees for doing nothing. Here, the most plausible inference is that Merkin knew he was lying to investors and turned a willful blind eye to the warning signs of Madoff's fraud in order to line his own pockets. ¶¶156, 160. Furthermore, based on Merkin's investment with Madoff, one could plausibly infer that Merkin thought that Madoff would never get caught and Merkin simply wanted to make money while the scheme lasted. Finally, Merkin knew that, even if he were to lose his entire investment with Madoff, the management and other fees he had improperly collected over the years far outweighed his direct losses. [22]

3. The TAC Sufficiently Alleges Reliance

Plaintiffs have alleged that they relied on Defendants' statements or omissions when purchasing their interests and shares in the Funds and that this reliance caused them to suffer an injury. ¶¶53, 88, 238, 276, 279.[23] Plaintiffs have also alleged that had they known the truth regarding the lack of due diligence performed by Defendants, the nature of the investments made by Merkin on behalf of the Funds, and the degree to which the Funds were invested with Madoff, all facts that were not disclosed by Defendants, Plaintiffs would not have purchased or otherwise

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[22] In *Acito*, 47 F.3d at 54, *Ressler v. Liz Claiborne, Inc.*, 75 F. Supp. 2d 43, 60 (E.D.N.Y. 1998) and *In re Merrill Lynch & Co. Research Reports Securities Litigation,* 272 F. Supp. 2d 243, 263 (S.D.N.Y. 2003) (Br. 16), the court found that the defendants' stock purchases outweighed any inference of motive that could be made from the sales. Here, the reverse is true.

[23] In this Circuit, reliance, also referred to as transaction causation, "requires only an allegation that but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction." *In re MBIA, Inc. Sec. Litig.*, 700 F. Supp. 2d 566, 595 fn.21 (S.D.N.Y. 2010). "At the pleading stage, a plaintiff satisfies the materiality requirement of Rule 10b-5 by alleging a statement or omission that a reasonable investor would have considered significant in making investment decisions." *Ganino*, 228 F.3d at 161. "Once the plaintiff establishes the materiality of the omission ... the burden shifts to the defendant to establish ... that the plaintiff did not rely on the omission in making the investment decision." *In re Sadia, S.A. Sec. Litig.,* No. 08 Civ. 9528 (SAS), 2010 U.S. Dist. LEXIS 72676, at *24 (S.D.N.Y. July 20, 2010) (citing *DuPont v. Brady*, 828 F.2d 75, 76 (2d Cir. 1987)).

acquired their limited partnership interests and shares in the Funds. ¶¶231, 277, 280. That is all that is required at the pleadings stage under Fed. R. Civ. P. 8(a). *See In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 489-90 (S.D.N.Y. 2006).[24]

Defendants argue that the Plaintiffs are precluded from alleging reasonable reliance because the offering memoranda contained cautionary language stating that the Funds would invest through outside investment managers and disclosing the risks inherent in Funds' investments. Br. at 19. As explained above, Defendants' purported cautionary language does not shield Merkin or GCC from liability because the cautionary language itself was false.[25]

C. The TAC Sufficiently Alleges Loss Causation

Loss causation is "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Lentell v. Merrill Lynch & Co. Inc.*, 396 F. 3d 161, 172 (2d Cir 2005), *see also Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005). "To plead loss causation," therefore, "the complaint[] must allege facts that support an inference that [defendants'] misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss

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[24] *See also In re NovaGold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 292 (S.D.N.Y. 2009) ("'Because materiality is a mixed question of law and fact,' it is ordinarily inappropriate for resolution at the motion to dismiss stage.")

[25] Defendants' citation to *Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 338-39 (S.D.N.Y. 1993) is inapposite here. The alleged misrepresentation relied upon in *Sable* was a tax opinion letter. In holding that the plaintiffs failed to allege reasonable reliance, the Court noted that the plaintiffs claimed to rely on the opinion letter for a general purpose clearly different from the purpose for which it was intended. Furthermore, the statements in the tax opinion were clearly contradicted by other statements at issue. *Brown v. E.F. Hutton Group*, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990)(Br. at 19) is also distinguishable. In *Brown*, the plaintiff alleged that the defendants made misrepresentations in written offering materials about the risks of investing in an oil and gas limited partnership. In granting defendants motion for summary judgment, the Court explained that the offering materials bespoke caution and sufficiently disclosed the exact relevant risks and uncertainties inherent in the investment. Here, the purported cautionary language itself was false and misleading.

absent the fraud." *Lentell*, 396 F.3d at 175. Here the appropriate inquiry is whether Defendants could reasonably foresee that their misrepresentations are causally linked to Plaintiffs' losses.

Defendants argue that the TAC fails to plead loss causation because it was Madoff's massive Ponzi scheme and not the disclosures in the offering memoranda that caused Plaintiffs' losses. That argument fails for the reasons articulated in *Anwar II*, 2010 U.S. Dist. LEXIS 86716, where the Court determined that the plaintiffs had established loss causation because "[t]he evaporation of Plaintiffs' investment was directly related to [defendant's] unwillingness or inability to discover and disclose that Madoff was running a Ponzi scheme." *Id.* at *92. Here, the TAC alleges in detail how Merkin allowed the Madoff fraud to flourish by ignoring specific facts and failing to monitor the Funds' investments. Defendants knew of but made a conscious decision not to pursue each and every one of the red flags detailed in the TAC. Defendants' failure to investigate red flags and Merkin's own outright misrepresentations and omissions from ultimately caused Plaintiffs' losses. *Lentell*, 396 F.3d at 173. In fact other investment professionals with less information available to them appropriately analyzed Madoff's strategies and operations and determined that it would be unwise to invest their clients' funds with Madoff. ¶¶135-142, 145-147, 149-155. Thus, those investment professionals avoided the losses that Defendants here failed to prevent.

Accordingly, Plaintiffs have adequately pled facts that support an inference that the Defendants' "misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud." *Lentell*, 396 F.3d at 175.[26]

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[26] Since Plaintiffs have satisfied the elements for pleading a violation of § 10(b) and Rule 10b-5, they have also fulfilled the requirements for pleading common law fraud. *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, No. 02 Civ. 0767 (LBS), 2003 U.S. Dist. LEXIS 11108 (S.D.N.Y. June 30, 2003). "The elements of common law fraud under New York law are: (1) a material representation or

D. Investors In The Ariel Fund State A Claim Under Section 10(b)

Defendants contend that under the recent Supreme Court decision in *Morrison v. National Australian Bank Ltd.*, 130 S. Ct. 2869 (2010), Plaintiffs who invested in the Ariel Fund fail to state a claim under Section 10(b) because they did not purchase any securities within the United States. Br. at 21-22. This argument ignores the fact that Plaintiffs Finkelstein and Nephrology and other members of the Class are U.S residents and that nothing in *Morrison* restricts claims by U.S. purchasers. Defendants also ignore that the Ariel Fund was permitted to sell its Class B participating shares in the U.S., on a private placement basis. *See* G. Mennitt Decl. Ex. F (Ariel Fund Subscription Agreement, at p. 7).

The first paragraph of *Morrison*, which defined the scope of the issues before the Court, makes clear that the decision does not prevent Section 10(b) claims by U.S. purchasers: "We decide whether §10(b) of the Securities Exchange Act of 1934 provides a cause of action to *foreign plaintiffs* suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges." 130 S. Ct. at 2875 (emphasis added). *Morrison* involved "no securities listed on a domestic exchange, and *all aspects* of the purchases complained of ... occurred outside the United States." *Id.* at 2888 (emphasis added). The Court held, in that context, that Section 10(b) applies to claims asserted in connection with the purchase or sale of "a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Id.* The petitioners in that case were "all Australians."

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omission of fact; (2) made with knowledge of its falsity; (3) with scienter or an intent to defraud; (4) upon which the plaintiff reasonably relied; and (5) such reliance caused damage to the plaintiff." *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *98 (citing *Bui v. Industrial Enter, of Am., Inc.*, 594 F. Supp. 2d 364, 371 (S.D.N.Y. 2009). Although the heightened pleading standards of the PSLRA do not apply to common law claims, "these elements are substantially identical to those governing §10(b), the identical analysis applies." *Rich v. Maidstone Fin.*, Inc., No. 98 Civ. 2569 (DAB), 2002 U.S. Dist. LEXIS 24510, AT *41 (S.D.N.Y. Dec. 19, 2002).

Id. at 2876. The *Morrison* Court accordingly did not consider or address any claims by U.S. purchasers or any claims with respect to a security identified as being listed or registered on a United States stock exchange.[27]

In contending that investors in the Ariel Fund cannot state a Section 10(b) claim because they did not purchase any securities in the United States, Defendants ignore the discussion of "domestic transactions" in *Morrison, 130 S. Ct. at 2885.*[28] The *Morrison* Court cited 17 C.F.R. §230.901 as evidence that provisions of the securities laws do not apply to "sales that occur outside the United States." 130 S. Ct. at 2885. That regulation does indeed exclude "sales that occur outside the United States," but it then goes on to clarify that sales in which the purchaser is located "in the United States" are *not* sales "outside the United States." Specifically, 17 C.F.R. §230.903(a)(1) defines "offshore transaction[s]" to *exclude* sales "made to a U.S. person." It follows that a transaction in which the purchaser is located in the United States is a domestic transaction. *Morrison* would not have cited those regulations if it was excluding those sorts of transactions from coverage as domestic transactions. To the contrary, *Morrison's* citation of those regulations demonstrates that transactions were being excluded as not domestic only when "*all aspects* of the purchases" – the purchasers, the seller, the exchange and so on – were located abroad. Here, Plaintiffs and the Class of investors in Ariel who are United States residents

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[27] Justice Stevens's separate opinion cited by Defendants (Br. at 21-22), to be sure, characterizes the majority's holding as extending to "American investor[s]." *Id.* at 2895. But Justice Stevens was *dissenting* from the majority's analysis on that point, and dissents regularly exaggerate the scope of the majority opinion to point out its perceived absurdities. It is well-settled that " 'Cassandra-like predictions in dissent are not a sure guide to the breadth of the majority's ruling.' " *Lee v. Kemna*, 534 U.S. 362, 387 (2002) (quoting *United States v. Travers*, 514 F.2d 1171, 1174 (2d Cir. 1974)); *African Trade & Info. Ctr. v. Abromaitis*, 294 F.3d 355, 362 (2d Cir. 2002). The majority in *Morrison* explicitly addressed only claims by "foreign" purchasers (130 S. Ct. at 2875); the case should not be read as extending beyond its express scope.

[28] Defendants' reliance on Judge Marrero's decision in *Cornwell v. Credit Suisse Corp.*, No. 08 Civ. 3758, 2010 U.S. Dist. LEXIS 76543 (S.D.N.Y. July 26, 2010), fails for the same reason. In *Cornwell*, Judge Marrero did not address the "domestic transaction" language in *Morrison*.

purchased their shares in the United States, including having the money required for the investment wired from U.S. banks.

This issue has also been addressed in other cases concerning the Madoff Ponzi scheme. *In re Banco Santander Sec.-Optimal Litig.*, No. 09-MD-02073-CIV-Huck/O'Sullivan, 2010 U.S. Dist. LEXIS 87580, at *26-27 (S.D. Fla. July 30, 2010), is distinguishable from the case at bar for the same reason *Morrison* is distinguishable - neither case was brought on behalf of American purchasers. *Banco Santander* involved off-shore purchasers in off-shore Bahamian investment funds closed to United States investors. *Id.* at 25. To the contrary, U.S. investors were permitted, and also solicited by Merkin, to invest in the Ariel Fund. *See* Brown Decl. Ex. 4 (2006 Form D filed with the SEC, executed by Merkin, attaching appendix identifying the states and the number of investors within such states to whom Ariel intended to solicit participating Ariel shares).

Defendants argue that the purchase of the Ariel interests occurred outside the United States because, pursuant to the Ariel Subscription Agreement, "[a] new shareholder's investment is effective only when it is accepted by Fortis Cayman in the Cayman Islands." Br. at 22. That argument has no merit. First, it is clear that the subscription application only says that: "If the subscription is not accepted, payment will be returned to the prospective Investor." *See* G. Mennitt Decl. Ex F (Ariel Fund Subscription Application, at p.1). Second, Defendants disregard the important fact that the securities transactions at issue did not occur until after Ariel investors had made their payments for participating shares to a Bank which was located in the United States. *See* Brown Decl. Ex. 5 (Ariel Fund Subscription Application instructing that payments for Ariel participating shares should be made to Chemical Bank, ABA No. 021-000128, New York, New York). As the Defendants recognize it is the "location of the transaction...[that]

controls whether Section 10(b) applies to a given sale or purchase of securities." Br. at 21 (*citing Morrison* at 2884).

For these reasons, the purchases of shares in the Ariel Fund are domestic transactions under *Morrison* and occurred in the United States, as a result, Plaintiffs state a claim for relief under Section 10(b).[29]

III. PLAINTIFFS HAVE ALLEGED VALID STATE LAW CLAIMS

A. Plaintiffs' State Law Claims Are Not Preempted By SLUSA

Defendants assert that Plaintiffs' state law claims should be dismissed because they are preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[30] Although Plaintiffs concede that this case is a "covered class action," Defendants cannot meet their burden because this case does not involve "covered securities" and the alleged fraudulent statements were not made "in connection with" the purchase or sale of a covered security.

A security is deemed a "covered security" if it is "traded nationally and listed on a regulated national exchange" such as the New York Stock Exchange or on the National Market System of the Nasdaq Stock Market. *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*,

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[29] In *Anwar II,* 2010 U.S. Dist. LEXIS 86716, at *69-71 (S.D.N.Y. Aug. 18, 2010), Judge Marrero considered the application of *Morrison* to plaintiffs who purchased shares in offshore funds. There, the plaintiffs argued, as Plaintiffs do here, that *Morrison* does not bar their Section 10(b) claims because the purchase or sale of the covered securities at issue occurred in the United States. *Id.* at 70. The court recognized that this issue presented a "novel and more complex application of *Morrison's* transaction test" and that "the uniqueness of the financial interests, structure of the transactions and relationships among the parties, the Court finds that a more developed factual record was necessary to inform a proper determination as to whether Plaintiffs' purchases of the shares of the Offshore Funds' shares occurred in the United States." *Id.* at 70-71. The Court deferred ruling on that question while the parties conducted discovery on this issue. *Id.* at *71. To the extent that the Court believes a more factual record needs to be developed before determining this issue, Plaintiffs respectfully respect that this Court defer ruling and allow the parties time to conduct discovery, as Judge Marrero did in *Anwar*.

[30] To dismiss an action based on SLUSA, the moving defendant must demonstrate that "(1) the action is a covered class action, (2) the claims are based on state law, (3) the action involves a covered security, and (4) the claims allege a misrepresentation or omission of material fact in connection with the purchase or sale of the security." *Feiner Family Trust v. Xcelera Inc.*, No. 10-CV-3431 (RPD), 2010 U.S. Dist. LEXIS 81041, at *10 (S.D.N.Y. Aug. 6, 2010); 15 U.S.C. § 78bb(f)(1), 77p(b).

("*Dabit II*"), 547 U.S. 71, 83 (2006), *rev'g Dabit v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 395 F.3d 25 (2d Cir. 2003) ("*Dabit I*"); 15 U.S.C. §77p(f)(3), 77r(b)(1)(A)-(B). Here, the Ascot and Gabriel limited partnership interests and the Ariel shares were only made available to qualified investors through confidential offering memoranda and never listed on an exchange. ¶¶53, 88. Consequently, Plaintiffs' investments in the Funds were not purchases of "covered securities" within the express meaning of SLUSA.

Recognizing that the Ascot and Gabriel limited partnership interests and the Ariel shares are not "covered securities," Defendants contend that the Funds invested with Madoff, who in turn purported to buy and sell securities covered by SLUSA and that therefore Plaintiffs' investments in the Funds "coincided" with security transactions. Br. at 24-25.[31] *Id.* But this argument goes too far and "overlooks the basic facts of this case, which concern misrepresentations and breaches of duties concerning shares purchased in the Funds." *Anwar II,* 2010 U.S. Dist. LEXIS 86716, at *48 (citing *Romano v. Kazacos*, 609 F.3d 512, 523 (2d Cir. 2010) ("SLUSA requires [a court's] attention to both the pleadings and the realities underlying the claims."). In *Anwar II*, the Court fittingly noted:

> Though the Court must broadly construe SLUSA's 'in connection with' phrasing, stretching SLUSA to cover this chain of investment – from Plaintiffs' initial investment in the Funds, the Funds' reinvestment with Madoff, Madoff's

[31] Defendants' analysis is misplaced and goes beyond the quotation that they rely on from *Dabit II*, 547 U.S. at 85, *rev'g Dabit I*, 395 F.3d 25. In *Dabit II*, a broker previously employed with Merrill Lynch brought a class action on behalf of himself and all other brokers who held certain stocks that they had purchased, for themselves and their clients, in reliance on the advice contained in misleading analyst reports issues by Merrill. 547 U.S. at 75. Merrill moved to dismiss the plaintiff's complaint under SLUSA. *Id.* at 76. After the court dismissed the complaint, the plaintiff was permitted and did amend the pleadings arguing that SLUSA did not apply because he represented a class of securities *holders*, not purchasers or sellers. *Id.* The Supreme Court determined that for purposes of SLUSA pre-emption, that distinction was irrelevant and that the alleged misconduct (*i.e.* fraudulent manipulation of stock prices) qualified as fraud "in connection with the purchase or sale" of "covered securities." *Id* at 89. As part of that determination, the Court stated that, "it is enough that the fraud alleged 'coincide' with a securities transaction – whether by the plaintiff or by someone else...The requisite showing, in other words, is 'deception 'in connection with the purchase or sale of any security...'" *Dabit II*, 547 U.S. at 85.

> supposed purchases of covered securities, to Madoff's sale of those securities and purchases of Treasury bills -- snaps even the most flexible rubber band.

2010 U.S. Dist. LEXIS 86716, at *50.[32]

This case involves false and misleading statements concerning Merkin's management of the Funds; the Funds' investment strategies, including the diversification of the Funds; and the monitoring and due diligence of Madoff and BMIS. These misrepresentations were made in connection with Plaintiffs' purchases of limited partnership interests or shares in the Funds, not in connection with the purported purchase or sale of securities by Madoff or BMIS. Accordingly, SLUSA does not preempt Plaintiffs' state law claims.[33]

B. Plaintiffs' State Law Claims Are Not Preempted By The Martin Act

New York State's Martin Act (the "Martin Act"), *N.Y. Gen. Bus. Law*, Art. 23-A, §§352-359 "prohibits various fraudulent and deceitful practices in the distribution, exchange, sale and purchase of securities, but does not require proof of intent to defraud or scienter." *Cromer Fin. Ltd. v. Berger*, No. 00 Civ 2498 (DLC), 2001 U.S. Dist. LEXIS 14744, at *11 (S.D.N.Y. Sept. 19, 2001). Defendants argue that Plaintiffs' common law claims for breach of fiduciary duty,

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[32] In addition to the holding in *Anwar*, and contrary to Defendants' position, numerous courts have declined to expand SLUSA's reach to all claims remotely involving a security. "To hold otherwise would extend the reach of SLUSA to any investment vehicle with covered securities in its portfolio." *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, No. 05 Civ. 9016 (SAS), 2010 U.S. Dist. LEXIS 13766, at *2 (S.D.N.Y. Feb. 16, 2010) ("Because plaintiffs purchased shares in hedge funds, rather than covered securities, SLUSA does not preempt plaintiffs' state-law claims); *LaSala v. UBS*, AG, 510 F. Supp. 2d 213, 240 (S.D.N.Y. 2007) ("Where the alleged conduct giving rise to the claim is too far removed from a securities transaction, the 'in connection with' requirement is not met."); *Norman v. Salomon Smith Barney, Inc.*, 350 F. Supp. 2d 382 (S.D.N.Y. 2004).

[33] In *Barron v. Igolnikov*, No. 09 Civ. 4471 (TPG), 2010 U.S. Dist LEXIS 22267 (S.D.N.Y. Mar. 10, 2010) and *Levinson v. PSCC Servs. Inc.*, No. 3:09-CV-00269 (PCD), 2009 U.S. Dist. LEXIS 119957 (D. Conn. Dec. 22, 2009), cases on which Defendants rely, both courts considered SLUSA preclusion of state fraud claims in situations where the plaintiffs had invested with Madoff through another entity. Plaintiffs respectively suggest that these cases were wrongly decided and that this Court should follow the reasoning articulated in *Anwar II* and *Pension Committeee* because "the securities 'at the heart of this case are non-covered interests in the Funds." *Anwar II*, 2010 U.S. Dist LEXIS 86716, at *51(*citing Pension Comm.*, 2010 U.S. Dist. LEXIS 13766, at *13).

gross negligence, unjust enrichment, and negligent misrepresentation are preempted by the Martin Act. Br. at 25. Defendants ignore important recent authority in this District that effectively overturns the body of prior case law on which they rely. *See Anwar v. Fairfield Greenwich Ltd. ("Anwar I")*, No. 09 Civ. 0118 (VM), 2010 U.S. Dist. LEXIS 78425 (S.D.NY. July 29, 2010) (finding that the Martin Act does not preempt common law claims); *Terra Sec. v. Citigroup, Inc.*, No. 09 Civ. 7058 (VM), 2010 U.S. Dist. LEXIS 84881 (S.D.N.Y. Aug. 16, 2010) (same).

In *Anwar I*, Judge Marrero examined the history and evolution of how different courts have interpreted the Martin Act and its relationship with private common law causes of action. Judge Marrero determined that previous cases supporting preemption were based on a misreading of precedent that had been taken out of context. In support of his determination that the Martin Act should not preempt common law claims, Judge Marrero reviewed the plain language of the statute and determined that, although it granted the Attorney General investigatory and enforcement powers, the law "nowhere mentions or otherwise contemplates erasing common law causes of action. *See N.Y. Gen. Bus. Law*, Art. 23-A, §§ 352-59." *Anwar I*, 2010 U.S. Dist. LEXIS 78425, at *21-22. While recognizing that many federal courts have held that the Martin Act preempts non-fraud common law causes of action, Judge Marrero noted that several New York state courts have reached the opposite conclusion. *Id.* at *31-48.[34] The Court also looked at the legislative history of the Martin Act and determined that it did not "suggest a desire on the part of the legislature to preempt common law actions" (*Id.* at *22) and that

[34] Judge Marrero also recognized that several judges in this District have also failed to give the Martin Act a broad preemptive ruling. *See e.g. Cromer Fin. Ltd. v. Berger*, 2001 U.S. Dist. LEXIS 14744; *Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc.*, 341 F. Supp. 2d 258, 272 (S.D.N.Y. 2004) (Scheindlin, J.) (citing Cromer); *In re Worldcom, Inc. Sec. Litig.*, 382 F. Supp. 2d 549, 560 n.18 (S.D.N.Y. 2005) (Cote, J.); and *Louros v. Kreicas*, 367 F. Supp. 2d 572, 595-96 (S.D.N.Y. 2005) (Kaplan, J.).

preemption would conflict with the policy goals of the Martin Act, which is "a consumer protection law intended to defeat any scheme whereby the public is exploited." *Id.* at *59. Finally, the Court also found persuasive that, in two cases currently pending before the Appellate Division, the NYAG filed amicus curiae briefs arguing "against total preemption." *Id.* at *20, 48. For example, the NYAG stated in his April 13, 2010 amicus brief in *CMMF, LLC v. J.P. Morgan Inv. Mgmt., Inc.*, New York Cty. Index No. 601924/09 (the "NYAG Amicus Brief"), that:

> [S]ome state trial courts, ... as well as various federal courts, have begun to advance an interpretation of the Martin Act that incorrectly finds preemption of private actions alleging fraud in the sale of securities, or tortious conduct similar in other ways to the fraud that can be the subject of an enforcement action by the Attorney General under the Martin Act.
>
> *The Attorney General has a strong interest in correcting this mistaken understanding of the statute. The Martin Act, which is enforceable only by the Attorney General, neither increased nor diminished the remedies available to private litigants.* First, there is no warrant in the text and history of the Martin Act for finding any intent to preempt existing common-law actions. Second, the policy argument most often advanced to support preemption is that it is needed in order to protect the exclusive authority of the Attorney General to enforce the Martin Act. But that argument is misplaced. Private common-law actions for the most part advance, and do not hinder, the Attorney General's fundamental mission under the Martin Act to eliminate fraudulent practices in the sale or purchase of securities across this State, because the Attorney General cannot possibly take sole responsibility for policing the marketplace in securities for fraud.

NYAG Amicus Brief at 1-2 (emphasis added). *See* Brown Decl. Ex. 6.

Defendants completely ignore *Anwar I* and the federal and state court cases that reject Martin Act preemption.[35] Based on the detailed analysis and holding in *Anwar I*, this Court should reject Defendants' argument that all of Plaintiffs' non-fraud common law claims are

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[35] In recent Madoff related decisions, state-courts have rejected the concept of Martin Act preemption. *See Sacher v Beacon Assoc. Mgt. Corp.*, No. 0005424/09, 2010 N.Y. Misc. LEXIS 992 (N.Y. Sup. Ct. 2010) (defendants' motion to dismiss plaintiffs' breach of fiduciary duty, aiding and abetting breach of fiduciary duty and gross negligence claims as preempted by the Martin Act were denied); *Hecht v Andover Assoc. Mgt. Corp.*, No. 006110/09, 2010 NY Misc. LEXIS 638 (N.Y. Sup. Ct., Mar. 12, 2010) (same).

preempted and avoid misapplication of the Martin Act before it "fossilizes any further." *Anwar I*, 2010 U.S. Dist. LEXIS 78425, at *62.

Defendants also argue that Plaintiffs' breach of fiduciary duty, gross negligence, and unjust enrichment claims should be dismissed for lack of standing because those claims belong to the Funds and not the limited partners or shareholders of the Funds. Br. at 27, fn 11. Defendants are wrong. *See Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *55 (holding that plaintiffs who were limited partners of Madoff feeder funds had standing to bring common law claims).[36] Here, Plaintiffs have asserted direct claims that belong to them only and cannot be asserted by the Funds. Plaintiffs are suing to recover their own losses from Merkin who induced investments in the Funds through misrepresentations and omissions regarding what the investors were investing in and what his role would be in managing the Funds, and his failure to perform due diligence and ignoring signs of fraud. The benefit of the recovery for these claims would go directly to Plaintiffs and not the Funds. As recognized by Judge Lowe, the fraud in this case alleged by the plaintiffs was committed on the shareholder investors rather than on the Funds. *See People v. Merkin,* 2010 N.Y. Misc. LEXIS 523, at *33 (rejecting defendant Merkin's argument that plaintiffs breach of fiduciary duty claim may not be asserted individually by shareholders).[37]

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[36] Under New York law, "a shareholder may sue individually when the wrongdoer has breached a duty owed to the shareholder independent of any duty owing to the corporation wronged. *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 409 (S.D.N.Y. 2005). "The same rules apply to actions by limited partners against a partnership." *Id.* In Delaware, when determining whether a claim is direct or derivative a court will inquire into "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)." *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A. 2d 1031, 1033 (Del. 2004).

[37] The cases cited by Defendants are not applicable. In *Stephenson v. Citco Group Ltd.*, 700 F. Supp. 2d 599, 608 (S.D.N.Y. 2010), the plaintiff lost $60 million as a limited partner in Greenwich Sentry, one of Madoff's feeder funds. As a result of his loss, plaintiff brought suit against third parties – Greenwich Sentry's administrators and its independent auditor. The Court dismissed certain claims against these

C. Madoff's Fraud Does Not Bar Plaintiffs' State Law Claims

Defendants' argument that Madoff's fraud constitutes a superseding criminal cause that bars Plaintiffs' state law claims for lack of causation is erroneous. Br. at 27. Contrary to Defendants' argument, Plaintiffs do not "concede" that Madoff's Ponzi scheme caused their losses. Although it is generally true that the criminal act of a third party breaks the chain of causation constituting what is referred to as a superseding or efficient intervening cause,

> [t]here are exceptions to this rule in cases where the tortfeasor created the condition that facilitated the criminal act and therefore should have naturally expected the criminal act to occur, or if the criminal act was otherwise foreseeable to the tortfeasor as a result of particular facts. In those cases, the criminal act is not deemed a superseding or efficient intervening cause.

See Ramey v. Dist. 141, Int'l Ass'n of Machinists & Aero. Workers, 473 F. Supp. 2d 365, 367 (E.D.N.Y. 2007). Indeed, in this case, Merkin facilitated Madoff's criminal acts by continuing to funnel him money from the Funds (which permitted the Ponzi scheme to flourish). Moreover it was foreseeable to Merkin and GCC that the failure to monitor and to follow up on numerous red flags would result in injury to Fund investors.[38]

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defendants after determining that plaintiff's allegations of mismanagement were derivative in nature. However, Defendants fail to point out that in *Stephenson*, the Court also determined that the plaintiff had standing to bring gross negligence, negligence and fraud claims against the defendants because those claims were direct as they alleged harm suffered by the plaintiff independent of the partnership. *See also W. Palm Beach Police Pension Fund v. Collins Capital Low Volatility Performance Fund II, Ltd.*, No. 09-80846-CIV-MARRA, 2010 U.S. Dist. LEXIS 74897, at *10 (S.D. Fla. July 26, 2010)(dismissing claim because the complaint "did not clearly articulate what each Defendant allegedly did improperly").

[38] *See Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *196-97 ("Whether or not Madoff's actions were reasonably foreseeable is a question of fact not proper for resolution at the motion to dismiss stage")(citing *McCarthy v. Sturm, Ruger, & Co.*, 916 F. Supp. 366, 372 (S.D.N.Y. 1996) ("[W]hether an intervening act severs the chain of causation depends on the forseeability of the intervening act and should be determined by the finder of fact.")).

D. The TAC Sufficiently Pleads Breach of Fiduciary Duty Claims

Plaintiffs have adequately alleged a breach of fiduciary duty against the Defendants. ¶¶247-252.[39] Merkin already has testified that he owed fiduciary duties to fund investors. ¶¶51, 80. Merkin held himself out as providing superior investment services and as having appropriate procedures to govern the Funds' investments so as to ensure the safety of class members' assets. Defendants' entrustment of these assets to Madoff without having conducted appropriate due diligence and monitoring, or following up on the numerous red flags about his operations, constitutes a breach of fiduciary duty. *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *101-02. Recently, in *Merkin*, 2010 N.Y. Misc. LEXIS 523, at *24-33, Justice Lowe found that Merkin breached his fiduciary duties to the Funds and their investors:

> By turning over the funds to Madoff without conducting adequate due diligence, despite information given to Merkin by his own associates, as well as some of the funds' investors, indicating that Madoff may have been engaged in misconduct, Merkin breached his fiduciary duties to the funds and the investors.
>
> ***
>
> Merkin was the investment advisor and manager to the investors of all four of the funds, and he had complete discretion with regard to how the monies were invested. The relationship created by the Offering Documents imposed on Merkin a duty to act with care and loyalty independent of the terms of those agreements.

Defendants assert that Plaintiffs' breach of fiduciary duty claim cannot proceed because the offering documents permitted Merkin to delegate investment discretion of the Funds' assets

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[39] In New York, the elements of a claim for breach of fiduciary duty are (1) "breach by a fiduciary of a duty owed to plaintiff"; (2) "defendant's knowing participation in the breach"; and (3) "damages." *Anwar II*, 2010 U.S. Dist. LEXIS 86716, at *100 (citing *Pension Comm.*, 446 F. Supp. 2d at 195). "A fiduciary relationship arises where 'one party's superior position or superior access to confidential information is so great as virtually to require the other party to repose trust and confidence in the first party,' and the defendant was 'under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.'" *Id.* citing *Pension* at *195-96. The existence of a fiduciary relationship is often a fact-specific inquiry that should not be decided on a motion to dismiss. *Musalli Factory for Gold & Jewelry v. JPMorgan Chase Bank, N.A.*, 261 F.R.D. 13, 26 (S.D.N.Y. 2009), *aff'd*, No. 09-1767, 2010 U.S. App. LEXIS 13199 (2d Cir. June 29, 2010). ("New York courts generally avoid dismissing a claim of breach of fiduciary duty under Rule 12(b)(6) because it usually involves a question of fact...").

to independent money managers. Br. at 30-31. But this argument fails for the same reasons articulated in *Merkin,* 2010 N.Y. Misc. LEXIS 523, at *34:

> Defendants' argument that there was no breach because the documents permitted Merkin to delegate his duties to other money managers without notice, lacks merit. The breach of fiduciary duty is not that he was permitted to and did delegate to other money managers. The breach alleged is based on Merkin's misrepresentations regarding his role in purportedly managing the funds and in conducting due diligence with regard to the investments, and in his concealment, both before and after the delegation of all or a portion of the funds to Madoff, that the funds were with Madoff.

E. The TAC Sufficiently Pleads Gross Negligence Claims

Plaintiffs have adequately alleged gross negligence claims against Defendants. ¶¶264-268. To state a claim for gross negligence, Plaintiffs must allege "conduct that evinces a reckless disregard for the rights of others or smacks of intentional wrongdoing." *Anwar II*, 2010 U.S. Dist. LEXIS 86716 at *98-99 (*citing AMW Materials Testing, Inc. v. Town of Babylon*, 584 F.3d 436, 454 (2d Cir. 2009)); *Sacher v. Beacon Assocs. Mgmt. Corp.*, No. 005424/09, 2010 N.Y. Misc. LEXIS 992, at *33 (N.Y. Sup. Ct. Apr. 26, 2010) ("Gross negligence is the failure to exercise even 'slight care' or 'slight diligence'"). Plaintiffs have alleged such conduct, with a litany of facts showing that Merkin and GCC acted in reckless disregard of their duties by failing to perform adequate due diligence before investing the Funds assets with Madoff; failing to monitor Madoff on an ongoing basis to any reasonable degree; and failing to take adequate steps to confirm Madoff's purported account statements, transactions and holdings of the Funds' assets.

Defendants contend Plaintiffs' gross negligence claim should be dismissed because those allegations are based entirely on the premise that Defendants were careless in investing with Madoff. Br. at 31-33. Defendants incorrectly argue that because they were purportedly acting within their duties which were limited by certain governing documents, any claim for breach of

those duties is nothing more than a breach of contract claim recast in tort language and should be dismissed. *Id.* "[I]it is well settled that the same conduct which may constitute the breach of a contractual obligation may also constitute the breach of a duty arising out of the relationship created by contract but which is independent of the contract itself." *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 408 (S.D.N.Y. 2005).[40] In this case although Defendants and Plaintiffs may have entered into agreements governing the investment of the Funds' assets, here Defendants also had independent duties that flowed from the governing documents, which they violated by funneling Plaintiffs' investments to Madoff. Accordingly, the Court should deny Defendants' motion to dismiss Plaintiffs' gross negligence claim.

F. The TAC Sufficiently Pleads Unjust Enrichment Claims

Plaintiffs have adequately alleged unjust enrichment claims against Defendants. ¶¶269-274.[41] Here Defendants were enriched by approximately ***728 million dollars*** at the expense of Plaintiffs and other investors in the Funds through the payment of management, administrative, professional and incentive fees. ¶¶15-16, 161, 163-164. To the extent that the assets of the Funds were invested with Madoff, any profits purportedly generated from those investments were illusory. ¶271. Thus, Merkin and GCC were overpaid by the portion of management and

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[40] *See also JDA Capital Partners LP v BNP Paribas Prime Brokerage, Inc.*, 2009 NY Slip Op 32050U, 17 (N.Y. Sup. Ct. Sept. 8, 2009) ("it is well established that in some cases tort liability may arise from a breach of a duty independent of a breach of contract"); *Clark-Fitzpatrick, Inc. v. Long Island R.R. Co.*, 70 N.Y.2d 382, 389, 516 N.E.2d 190, 521 N.Y.S.2d 653, 656 (1987). "Professionals such as investment advisors, who owe fiduciary duties to their clients, 'may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties,' since in 'these instances, it is policy, not the parties' contract, that gives rise to a duty of due care.'" *Bullmore v. Ernst & Young Cayman Is.*, 45 A.D.3d 461, 463 (N.Y. App. Div. 1st Dep't 2007) (citing *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540 (N.Y. Ct. App. 1992)).

[41] "To state a claim for unjust enrichment in New York, a plaintiff must allege that (1) defendant was enriched; (2) the enrichment was at plaintiff's expense; and (3) the circumstances were such that equity and good conscience require defendants to make restitution." *Anwar II*, 2010 U.S. Dist. LEXIS 86716 at *117-118 (citing *Kidz Cloz, Inc. v. Officially for Kids, Inc.*, 320 F. Supp. 2d 164, 177 (S.D.N.Y. 2004).

incentive fees that stemmed from assets invested with and profits generated by Madoff. *Id.* Because Defendants have been unjustly enriched, equity requires all incentive fees, management fees and professional fees that flowed from the Funds' investments with Madoff be disgorged and refunded to the Funds for the benefit of their limited partners and shareholders. ¶274.

Defendants argue that Plaintiffs' unjust enrichment claim are foreclosed because their rights with respect to a dispute over management and incentive fees are governed by the contractual terms set forth in the Governing Documents. Br. 33-34. To the contrary, the existence of an express agreement only precludes an unjust enrichment claim where the scope of the contract covers the entirety of the dispute between the parties. *Las Olas Investor Group, LLC v. Las Olas Tower Co.*, No. 06 Civ. 7781 (SHS) (FM), 2008 U.S. Dist. LEXIS 661 at *5 (S.D.N.Y. Jan. 2, 2008) ("Under New York law, it is improper to seek damages for unjust enrichment 'in an action sounding in quasi contract where the suing party has fully performed on a valid written agreement, *the existence of which is undisputed, and the scope of which clearly covers the dispute between the parties.*'"). In this case, Defendants received higher fees than contemplated under the contracts because their fees were based on a percentage of the capital invested in the Funds and an incentive fee of 20% of any profits – which were based on fictitious returns from Madoff. Thus, Plaintiffs' claim of unjust enrichment goes beyond the scope and subject matter of the contracts at issue since a portion of the fees collected were a direct consequence of the Madoff Ponzi scheme and therefore were never "earned" by him.[42]

[42] Moreover, whether an express contract clearly covers the entirety of the dispute between the parties, so as to preclude an unjust enrichment claim, often involves factual issues not properly resolved at the pleading stage. *Nat'l City Commercial Capital Co., LLC v. Global Golf, Inc.*, No. 99-CV-0307 (JFB) (AKT), 2009 U.S. Dist. LEXIS 42780 (E.D.N.Y. May 20, 2009); *Dagen v. CFC Group Holdings, Ltd.*, No. 00 Civ. 5682 (DAB) (THK), 2003 U.S. Dist. LEXIS 1225 (S.D.N.Y. Jan. 24, 2003).

G. The TAC Sufficiently Pleads Negligent Misrepresentation Claims

To sufficiently allege a claim of negligent misrepresentation, a plaintiff must plead that

> (1) the defendant had a duty, as a result of a special relationship, to give correct information; (2) the defendant made a false representation that he or she should have known was incorrect; (3) the defendant knew that the plaintiff desired the information supplied in the representation for a serious purpose; (4) the plaintiff intended to rely and act upon it; and (5) the plaintiff reasonably relied on it to his or her detriment.

Anwar II, 2010 U.S. Dist. LEXIS 86716, at *102-03 (citing *Pension Comm.*, 446 F. Supp. 2d at 198). Each of these elements have been properly alleged in the TAC. ¶¶269-274.

A "special relationship" existed here because Plaintiffs were induced into a business transaction with Merkin based upon statements in the offering memoranda that laid out a specific investment strategy and detailed how Merkin would monitor investment managers like Madoff. The "false representations" made by Defendants were known or should have been known in the same manner as described above for the purposes of the §10(b) federal securities claims. The TAC also adequately alleges that Defendants knew that information about Madoff and the Funds' strategy was desired by the Plaintiffs for the serious purpose of deciding whether to invest with Merkin. Finally, the TAC also properly alleges Plaintiffs' intent and actual reliance on this information to their detriment for the same reasons articulated in the causation discussion above.

H. Defendants' Conduct Is Not Shielded By The Exculpatory Clauses

The exculpatory clauses contained in the Ascot and Gabriel limited partnership agreements and the Ariel investment advisor agreement do not shield Defendants from liability for Plaintiffs' breach of fiduciary duty, unjust enrichment and negligent misrepresentations claims because: (1) the alleged misconduct falls outside the scope of the protection afforded by

the exculpation provisions; and (2) the existence of an exculpation clause is an affirmative defense that does not mandate dismissal at the pleading stage.

As explained in detail above, the TAC sets forth facts demonstrating that Defendants breached their duties of good faith and fair dealing and engaged in willful misconduct or grossly negligent acts.[43] The TAC includes numerous allegations of Defendants' bad faith, recklessness and willful disregard of their duties. Merkin's conscious disregard of the numerous flags regarding Madoff's operations and purported results is the exact type of willful misconduct that courts have found to fall in the bad faith exception to exculpatory clauses. *See e.g., Buckley v. O'Hanlon*, No. 04-955 (GMS), 2007 U.S. Dist. LEXIS 22211, at *18 (D. Del. Mar. 28, 2007) (directors not insulated by exculpation clause where they acted with willful indifference and "ignore[ed] red flags"); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006) (holding that "an intentional dereliction of duty" or "a conscious disregard for one's responsibility...[was] a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith").[44] In addition, under both Delaware and New York law, the existence of an

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[43] Under Delaware Law, such wrongful acts cannot be exculpated because "a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." 6 Del. C. § 17-1101(f); *Schuss v. Penfield Partners, L.P.*, No. 3132-VCP, 2008 Del. Ch. LEXIS 73, at *32-33 (Del. Ch. June 13, 2008). Under New York law, contractual limitations on liability do not exculpate Defendants for "willful or grossly negligent acts." *Official Comm. of Unsecured Creditors v. Donaldson, Lufkin & Jenrette Sec. Corp.*, No. 00 Civ. 8688 (WHP), 2002 U.S. Dist. LEXIS 3747, at *47 (S.D.N.Y. Mar. 6, 2002); *Travelers Cas. & Sur. Co. v. Dormitory Auth.*, Master File No. 07 Civ. 6915 (DLC) 2010 U.S. Dist. LEXIS 88320 (S.D.N.Y. Aug. 26, 2010) (citing *Kalisch-Jarcho, Inc. v. City of N.Y.*, 58 N.Y.2d 377, 385-86, 61 N.Y.S.2d 746, 749-50 (N.Y. Ct. App. 1983) ("an exculpatory clause is unenforceable when, in contravention of acceptable notions of morality, the misconduct for which it would grant immunity smacks of intentional wrongdoing."); *Gross v. Sweet*, 49 N.Y.2d 102, 106 (N.Y. Ct. App. 1979).

[44] Defendants cite to Section 8 of the Ariel IAA in an attempt to show that Merkin cannot be liable to Ariel Fund investors for losses due to the "negligence, dishonesty or bad faith of any....broker or other agent of the Investment Advisor, provided that such...broker or agent was selected, engaged or retained by the Investment Advisor with ***reasonable care***." (emphasis added). Br. at 29, fn 12. As shown in the Complaint, this is exactly what the Defendants failed to do.

exculpatory provision is an affirmative defense that defendants bear the burden of proving ***after discovery***, and, therefore, cannot be the basis for dismissal at this stage of the proceedings.[45]

CONCLUSION

For the reasons set forth herein, the motion to dismiss filed by Merkin and GCC should be denied in it entirety.

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Respectfully submitted,

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[45] *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. Sup. Ct. 1999); *In re Midway Games Inc.*, 428 B.R. 303, 317 (Bankr. D. Del. 2010) ("The exculpation clause is an affirmative defense and the determination of the viability of that defense is not proper at [the dismissal] stage.") (citing *In re The Brown Schools*, 368 B.R. 394, 401 (Bankr. D. Del. 2007)); *Ad Hoc Comm. of Equity Holders of Tectonic Network, Inc. v. Wolford*, 554 F. Supp. 2d 538, 561 (D. Del. 2008). In New York, "a motion to dismiss is usually not the appropriate vehicle to raise affirmative defenses to a complaint...." *Ortiz v. Guitian Music Bros., Inc.*, No. 07 Civ. 3897, 2009 U.S. Dist. LEXIS 65191, at *5 (S.D.N.Y. July 22, 2009).