Anwar et al v. Fairfield Greenwich Limited et al Doc. 463

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

ANWAR, *et al.*	
Plaintiffs,	Case No: 09-CV-118 (VM)
v.	ECF Case
FAIRFIELD GREENWICH LIMITED, *et al.*,	
Defendants.	

REPLY MEMORANDUM IN SUPPORT OF PRICEWATERHOUSECOOPERS LLP'S MOTION TO DISMISS

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INTRODUCTION

Plaintiffs have not demonstrated the viability of a single claim against PwC Canada. This is not surprising, since the federal courts have resoundingly rejected similar attempts to hold auditors of fund financial statements – including PwC Canada – liable to individual investors on the assertion that they should have uncovered the Madoff fraud. *Stephenson v. Citco Group Ltd.*, 2010 WL 1244007 (S.D.N.Y. Apr. 1, 2010) (all claims against PwC Canada were dismissed because they were either derivative in nature, preempted by the Martin Act, or failed to state a claim); *In re Tremont Sec. Law, State Law, and Ins. Litig.*, 2010 WL 1257580 (S.D.N.Y. Mar. 30, 2010) (Section 10(b) claim against auditors dismissed for failure to state a claim; state-law claims pre-empted by the Martin Act); *Meridian Horizon Fund v. Tremont Group Holdings, Inc.*, 2010 WL 1257567, at *8 (S.D.N.Y. Mar. 31, 2010) (same); *CRT Invs. v. Merkin*, Case No. 601052/09 (N.Y. Sup. Ct. May 7, 2010) (same). These courts have concluded that "[t]o impose liability on the [a]uditors would expand their limited, circumscribed duty impermissibly." *In re Tremont*, 2010 WL 1257580, at *6.

Specifically, plaintiffs' federal securities law claims fail because they do not – and cannot – allege scienter. They ludicrously argue that the only "plausible" inference is that PwC Canada acted recklessly, when the far more logical and compelling conclusion to be drawn from the allegations is that PwC Canada was one of hundreds of entities, including institutions like the SEC and FINRA, whom Madoff took great pains to deceive over the course of at least two decades. Plaintiffs fail to adequately plead reliance and loss causation as well.

With respect to their state law claims, not only do plaintiffs lack standing to bring claims rightly belonging to the Funds, but those claims are also preempted by SLUSA and the Martin Act. In addition, plaintiffs' opposition brief only underscores that each of plaintiffs' state-law claims also fail to state a claim upon which relief may be granted.

ARGUMENT

I. PLAINTIFFS' SECURITIES LAW CLAIM FAILS.

A. Plaintiffs Do Not Adequately Allege Scienter.

Plaintiffs' theory is not that PwC Canada participated in or purposefully failed to uncover the Madoff fraud, but that PwC Canada consciously conducted reckless audits of the Fairfield Greenwich funds. (Pl. Opp. PwC 15) But, as Judge Griesa recently held in dismissing virtually identical claims against Ernst & Young and KPMG, "alleging a shoddy audit in violation of GAAS does not establish the intent to defraud required to maintain a claim for securities fraud." *In re Tremont*, 2010 WL 1257580, at *5. Judge Holwell's decision dismissing PwC Canada similarly concluded that the plaintiff had failed to state a claim for fraud under state law because, as here, PwC Canada "is not plausibly alleged to have had knowledge of specific red flags" that could, in theory, form the basis of a fraud claim. *Stephenson*, 2010 WL 1244007 at *20; *CRT Invs.*, Case No. 601052/09 at 27 (where auditor's "only role was to audit the financial statements" of funds that invested with Madoff, "[t]here is no rational basis for inferring that [auditor] knowingly made misrepresentations"). In both the *Stephenson* case and this case, while "the complaint alleges facts sufficient to support the conclusion that certain suspicious facts surrounded Madoff's operation [it] does not connect those red flags to PwC through factually sufficient allegations that PwC actually knew of or uncovered them." 2010 WL 1244007 at *20.

Plaintiffs also conflate PwC Canada's role as an auditor of the financial statements of the Funds with that of an auditor of Madoff's investment firm. (Pl. Opp. PwC 11-14) There is no precedent for holding an auditor liable for securities fraud for failing to uncover a fraud perpetrated ***on***, as opposed to ***by***, the auditor's client. Indeed, plaintiffs cite no case in which allegations that an auditor missed alleged red flags at a third party, as opposed to the audit client, established scienter for a Section 10(b) or a common law fraud claim. As Judge Griesa put it:

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

In re Tremont, 2010 WL 1257580, at *6; *CRT Invs.*, Case No. 601052/09 at 27.

Finally, plaintiffs acknowledge the legal requirement that the inference that PwC Canada committed fraud must be at least as compelling as any competing inference, and yet, they claim that no competing inference exists. (Pl. Opp. PwC 16). This ignores reality. PwC Canada was one of hundreds of entities (government agencies, auditors, fund managers, quantitative analysts, and sophisticated investors among them) whom Madoff successfully duped over the course of twenty years or more. As Judge Griesa held, and as common sense dictates, "the more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme and eluding the SEC and other financial professionals." *In re Tremont*, 2010 WL 1257580, at *5.

B. Plaintiffs Do Not Adequately Allege Reliance.

The reliance cases cited by plaintiffs are distinguishable. In *Varghese v. China Shenghuo Pharm. Holdings, Inc.*, 672 F. Supp. 2d 596, 608 (S.D.N.Y. 2009) (Pl. Opp. PwC 18), for example, the reliance requirement was met because the two named plaintiffs explicitly alleged that they "purchased [the company's] common stock after [the company] made alleged false statements and before the corrective disclosure[,]" relied on the defendants' misrepresentations, and would not have purchased the stock had they known the information that defendants failed to disclose. There are no such specific allegations supporting the claims of the individual plaintiffs in this case. Indeed, according to their own allegations, 54 of the 116 plaintiffs last invested

monies before the April 24, 2007 issuance date of PwC Canada's reports on the Funds' 2006 financial statements, the first year it was engaged. (Pl. Opp. PwC 18 n.16) None of these plaintiffs can plausibly assert reliance on PwC Canada's audit opinions, and the remainder cannot slide by with rote allegations of "direct or indirect" reliance. (SCAC ¶¶ 429, 435-36)

C. Plaintiffs Have Not Pled Loss Causation.

Plaintiffs' causation arguments (Pl. Opp. PwC 20-21) miss the point. They cite no case finding loss causation where an auditor failed to discover fraud at a third-party custodian. Losses resulting from Madoff's fraud were simply not foreseeable to PwC Canada in the course of auditing the Funds' financial statements.

II. PLAINTIFFS DO NOT HAVE STANDING TO PURSUE STATE LAW CLAIMS AGAINST PWC CANADA.[1]

Plaintiffs effectively concede that all of their claims are derivative – with the possible exception of their misrepresentation claims. (Pl. Opp. PwC 58 (citing fraudulent inducement cases); Pl. Opp. FG Defs. 62 n.59, 63-67; Aff. of Robert Miles, Q.C. (Docket No. 408) ¶¶ 9-10) But their negligent misrepresentation claim against PwC Canada (Count 14) does not qualify as a direct claim. Both Delaware and BVI law establish that a shareholder can make a direct claim if "the duty breached was owed to the stockholder and [if] he or she can prevail ***without showing an injury to the corporation***." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004) (emphasis added); *Johnson v. Gore Wood & Co.* [2002] 2 AC 1, 36 (Miles

[1] Tellingly, plaintiffs devote but a single paragraph to the standing issue in their opposition to the PwC Defendants' motion. (Pl. Opp. PwC 58) They incorporate the standing arguments they made in opposition to the Fairfield Defendants' motion without explaining how or why those arguments would apply to PwC Canada. (*Id.*) This ignores key facts unique to PwC Canada. As a third-party service provider to the Funds, it is clear that PwC Canada's duties were to the Funds, any alleged representations were made to the Funds, and any alleged harm caused was inflicted upon the Funds; investors only come into play derivatively. *See Stephenson*, 2010 WL 1244007, at *9. Plaintiffs also assert that the defendants exempt plaintiffs' state law claims of fraudulent or negligent misrepresentations from their standing arguments. (Pl. Opp. to FG Defs. 62 n.59) To the contrary, PwC Canada argued plaintiffs lacked standing to assert ***any*** state law claims. (PwC Canada Mem. Supp. MTD 12-13)

Aff. Ex. 2, Docket No. 408-7 at 6) (English law) ("In some cases the answer [to the reflective loss issue] will be clear, as where the shareholder claims the loss of dividend or a ***diminution in the value of a shareholding attributable solely to the depletion of the company's assets***[.]") (emphasis added). In other words, to maintain a direct claim on an inducement theory, not only must plaintiffs have an analytically distinct legal claim or theory of recovery, but they must have also experienced an injury that does not implicate the injury to the corporation. *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1176-77 (Del. Ch. 2006) ("[F]raudulent inducement claims where the only alleged injury is inextricably linked to a corporate injury are derivative claims.") (citing *Tooley*).[2]

In a factually indistinguishable case, the New York Supreme Court rejected plaintiffs' fraudulent inducement claims against partnership auditors where the injury was the diminution of share value, and therefore indistinct from the injury suffered by the partnerships. *Continental Cas. Co. v. PricewaterhouseCoopers LLP*, 2007 WL 3992606 (N.Y. Sup. Ct. Nov. 7, 2007), *aff'd*, 869 N.Y.S.2d 506 (1st Dep't 2008); *In re WorldCom, Inc.*, 323 B.R. 844, 856 (S.D.N.Y. Bankr. 2005). To allow a contrary result would invite the potential for double recovery – the Funds on their negligence and contractual claims, and investors, whose losses derive from the diminished value of their interests, on their inducement claims. That result is untenable.

III. PLAINTIFFS' STATE LAW CLAIMS ARE PREEMPTED.

A. SLUSA Preempts Plaintiffs' State-Law Claims.

Plaintiffs contend that their state-law claims are not preempted by SLUSA because they do not allege that the misrepresentations at issue were made "in connection with the purchase or

[2] Plaintiffs' experts agree. (Miles Aff. ¶ 4 ("[W]here the loss of the company matches or 'franks' the loss of the shareholder, the shareholder's claim is barred."); *id.* at ¶ 6 ("Where [the reflective loss rule] applies, it prevents a plaintiff who has his ***own*** claim from seeking damages.") (emphasis in original); *id.* at ¶ 19(b) (reflective loss principle "does not bar the Plaintiffs for claiming for ***losses*** which are separate and distinct from those of the Funds[.]") (emphasis added)).

sale of a covered security." (Pl. Opp. FG Defs. 85-93) All courts that have confronted this issue in Madoff-related litigation disagree. *Barron v. Igolnikov*, 2010 WL 882890, at *5-6 (S.D.N.Y. Mar. 10, 2010); *Backus v. Conn. Cmty. Bank, N.A.*, 2009 WL 5184360, at *8-9 (D. Conn. Dec. 23, 2009); *Levinson v. PSCC Servs., Inc.*, 2009 WL 5184363, at *14 (D. Conn. Dec. 23, 2009). Those courts determined that the "covered security" prong was met by virtue of Madoff's representations that he dealt in publicly traded equities, and that alleged misrepresentations by auditors and fund managers were made "in connection with the purchase or sale" of such securities.

Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Sec., LLC, 2010 WL 546964 (S.D.N.Y. Feb. 16, 2010) (cited at Pl. Opp. FG Defs. 90-92), is distinguishable. In *Pension Comm.*, plaintiffs alleged that the fund administrator and other defendants made misstatements regarding the net asset values and other performance information for the funds in which plaintiffs invested. The administrator argued that the alleged scheme also involved the funds' misrepresentations that a majority of fund assets would be invested in national exchange-traded securities when, in reality, they were mostly invested in worthless shell companies whose share price the fund managers manipulated to show profitability. The court concluded that SLUSA did not apply because the alleged fraud related exclusively to the defendant hedge funds "rather than to the covered securities in the portfolios." *Id*. at *2. The court specifically distinguished *Backus* on the grounds that the *Backus* plaintiffs "could claim that they deposited their money in the bank for the purpose of purchasing covered securities," placing those securities "at the heart of" that case, whereas in *Pension Comm.*, the fraud lay only with fund itself. *Id*. at *3 n.27.

The case at bar is much closer to *Backus* than *Pension Committee*, because although this case, like *Pension Committee*, also involves hedge fund investments, the "covered securities" at issue in the Madoff fraud are at the heart of this case, and of the allegations against the PwC Defendants. *Backus*, 2009 WL 5184360, at *5. Unlike *Pension Committee*, the Funds' offering memoranda and other marketing documents explicitly stated that Fund assets would be invested in S&P 100 Index equity securities and options. (SCAC ¶¶ 184, 191, 195, 233) Indeed, the gravamen of plaintiffs' allegations against PwC Canada is that the audit report misrepresented the accuracy of Funds' financial statements, which showed that funds were invested in covered securities. (SCAC ¶ 260) PwC Canada is not alleged to have made any misrepresentations about the Funds' financial statements that did not relate to the Funds' investments in covered securities. Thus, the "in connection with the purchase or sale of any security" test is met.

B. The Martin Act Preempts Plaintiffs' State Law Tort Claims.

Plaintiffs assert that the Martin Act does not preempt their common law claims. This requires them to argue that the entire body of case law upholding the Act's preemptive effect (including the Second Circuit's decision in *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001), dozens of this Court's decisions, and even recent cases that are on all fours with this one) are all wrongly decided. *Meridian*, 2010 WL 1257567, at *8; *In re Tremont*, 2010 WL 1257580, at *7-8; *Barron*, 2010 WL 882890, at *5-6; *CRT Invs.*, No. 601052/09 at 22. As those cases have reaffirmed, "the line of cases that plaintiffs advance has been rejected repeatedly by courts in this district." *In re Tremont*, 2010 WL 1257580, at *8. Plaintiffs offer no sound basis for the Court to ignore the vast weight of authority against their position, nor could they given the New York Legislature's failure to amend the Act to establish the private right of action plaintiffs seek in the 20 years since the New York Appellate Division – followed by many other courts – concluded that such claims are preempted.

Plaintiffs' argument (Pl. Opp. FG Defs. 103-05) that their claims do not fall within the geographic purview of the Martin Act does not pass the red-face test. "[A] transaction is 'within or from' New York for purposes of the Martin Act if a plaintiff alleges that a 'substantial portion' of the events giving rise to a claim occurred in New York." *Stephenson*, 2010 WL 1244007, at *14 (quoting *Heller v. Golden Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 611 n.9 (S.D.N.Y. 2008)). It is evident on the face of the complaint that the transactions at issue here were "within or from" New York. Madoff's fraud was based in New York. Plaintiffs have alleged that investors wired their investments to an escrow account in New York (SCAC ¶ 157); that investor assets were then transferred to sub-custodian BLMIS in New York (*id*. ¶¶ 159-160); that most of the individual defendants worked out of Fairfield Greenwich Group's New York office, and other defendants were registered to do business in New York or had their principal place of business in New York (*id*. ¶¶ 118, 120, 122, 124-129, 132-34, 136-38, 142-43 146); and that two of the four Funds were marketed to investors in New York (*id*. ¶¶ 172-73). Courts in Madoff-related cases have found that similar facts provide ample support to conclude that the Martin Act applies. *Stephenson*, 2010 WL 1244007, at *15; *Meridian*, 2010 WL 1257567 at *8.

IV. EACH OF PLAINTIFFS' STATE LAW CLAIMS FAILS.

A. Plaintiffs' Negligence Claims Fail.

As a matter of New York law, there is no "gross negligence" claim against accountants. Even plaintiffs' own authority makes this point. In *Foothill Capital Corp. v. Grant Thornton LLP*, 715 N.Y.S.2d 389 (N.Y. App. Div. 1st Dep't 2000), the court concluded that the complaint stated a claim of "gross negligence and recklessness sufficient to give rise to an inference of fraud." *Id*. at 390. Without allegations tantamount to fraud, pled with the particularity required of fraud claims, *i.e.* a viable fraud claim, "gross negligence" is not enough.

Plaintiffs' negligence claim also fails. The recent decision in *CRT Invs.*, Case No. 601052/09 at 23-24 (N.Y. Sup. Ct. May 7, 2010) is illustrative. In *CRT Invs.*, the court held:

> The fact that [investors] were entitled to and received a copy of the audited financial statements, or that BDO Seidman knew that the investors would rely upon the information contained in the financial statements, does not establish the requisite linking conduct (*see Houbigant, Inc. v. Deloitte & Touche LLP*, 303 AD2d 92, 94-95 [1st Dept. 2003]). BDO's work in the course of the audit was performed pursuant to professional standards applicable in the context of ***any*** audit, and ***was not undertaken pursuant to any specific duty owed to plaintiffs*** (*id.*). Therefore, plaintiffs cannot establish the direct nexus necessary to give them a claim against BDO Seidman for negligent misrepresentation.

Id. (emphasis added). This is exactly the case here. Plaintiffs cannot dispute that PwC Canada was acting on behalf of the Funds, and the fact that investors might review the statements was "merely one possibility among many." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 182 (N.Y. Ct. App. 1931). The engagement letters between PwC Canada and the Funds make it clear that investors were not named or implied promisees or intended beneficiaries of PwC Canada's audit reports. (Duffy Decl. Exs. A-D at 2-3) And even PwC Canada's alleged knowledge that investors would receive its reports and that its name would be used in marketing, if true, would be legally insufficient. *CRT Invs.*, Case No. 601052/09 at 23-24. Thus, plaintiffs did not and cannot allege the required privity with PwC Canada.

B. Plaintiffs' Third-Party Beneficiary Claim Fails.

Notwithstanding plaintiffs' citation to pre-*Twombly* and non-New York cases, plaintiffs cannot survive a motion to dismiss simply by pleading the legal conclusion that they were third-party beneficiaries – particularly when that conclusion is directly contradicted by the contracts incorporated in their complaint. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). The complaint does not – and cannot – allege the primary purpose of PwC Canada's audits of the Funds' financial statements was to benefit individual investors. As Judge Holwell found, the contracts between PwC Canada and the Funds do not support a third-party beneficiary claim.

Stephenson, 2010 WL 1244007, at *9 n.12 ("If the Court were to reach this question, it would hold that Stephenson was not an intended beneficiary of the agreements.").

C. Plaintiffs' Aiding And Abetting Claims Fail.

Plaintiffs bafflingly equate PwC Canada's alleged "actual knowledge" of "red flags" regarding BLMIS with alleged "actual knowledge" of the Fairfield Defendants' alleged breach of fiduciary duty. (Pl. Opp. PwC 41-42) Likewise, they equate PwC Canada's alleged "knowing[] fail[ure] to properly audit" with the completely unrelated concept of knowing participation in the Fairfield Defendants' alleged breach of duty. (*Id.* at 43) These contortions cannot rescue plaintiffs from their failure to plead any plausible basis for a claim that PwC Canada aided and abetted any breach of fiduciary duty. As for aiding and abetting fraud, plaintiffs' allegations charge PwC Canada with constructive knowledge of the Fairfield Defendants' alleged negligence (SCAC ¶ 457), not actual knowledge of their alleged fraud. *CRT Invs*, Case No. 601052/09 at 28 (dismissing aiding and abetting claim against fund auditor; complaint did not allege that auditor knew of or assisted investment manager's alleged fraud).

D. Plaintiffs' Unjust Enrichment Claim Fails.

Plaintiffs did not respond to PwC Canada's argument that plaintiffs' unjust enrichment claim (Count 33) fails because it is barred by the express contracts with the Funds and because plaintiffs did not pay PwC Canada's fees. (PwC Canada Mem. Supp. MTD 25) Therefore, plaintiffs should be deemed to have abandoned this claim.

CONCLUSION

For the reasons set forth above, plaintiffs have failed to state any viable claim for relief, and their case should be dismissed with prejudice.

Dated: May 21, 2010

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