1. Plaintiffs Assert Direct Claims That Can Only Be Pursued by the Investors

Plaintiffs assert direct claims that belong to them only, and could not be asserted by the Funds. Contrary to Defendants' assertion, Plaintiffs here are not suing to recover the losses which the Funds incurred by investing in Madoff, but to recover their *own* losses resulting from being induced to make and then maintain investments in the FGG Funds. The FGG Defendants marketed the Funds to Plaintiffs using misleading offering materials, and thus Plaintiffs are the proper parties to assert fraud and negligent misrepresentation claims; the Funds, not having been defrauded by their own marketing materials, cannot assert such claims on behalf of their investors. Defendants cite no authority to the contrary.[60] This is because fraud and misrepresentation are textbook examples of direct claims that can be pursued by investors who relied on the misleading statements in making and holding investments. *See, e.g. Primavera Familienstiftung v. Askin,* 130 F. Supp. 2d 450, 495 (S.D.N.Y. 2001) ("Investors may assert a fraud claim based on the theory that they were induced to make and/or retain their investments") (footnote omitted); *Jones v. PriceWaterhouseCoopers, LLP*, 2004 NY Slip Op 51789U, at 4 (Sup. Ct. 2004) ("[D]irect claims, such as fraud in the inducement of their initial investment in the Partnership . . . are not derivative"); *Pension Comm.*, 446 F. Supp. 2d at 205 (shareholders

[60] In challenging Plaintiffs' standing to bring fraud claims, Defendants cite *Manzo v. Rite Aid Corp.*, 2002 WL 31926606, at *6 (Del. Ch. Dec. 19, 2002), omitting that the case is pre-*Tooley* and the relevant discussion pertains to claims for breach of fiduciary duty, not fraud or misrepresentation. *Tooley* expressly did away with the requirement that a shareholders' claim must be dissimilar to the losses suffered by other shareholders. Other cases on which Defendants rely are similarly inapposite, in that they involve only claims of mismanagement. See *In re Goldman Sachs Mutual Funds Fee Litig.*, 2006 WL 126772 (S.D.N.Y. Jan 17, 2006) (claims of mismanagement – not fraud or misrepresentation – are derivative); *Dieterich v. Harrer*, 857 A.2d 1017, 1027 (Del. Ch. 2004) (same); *Litman v. Prudential-Bache Properties, Inc.*, 611 A.2d 12 (Del. Ch. 1992) (same). Furthermore, the overwhelming majority of authority cited by Defendants involves claims by shareholders against the directors of the funds in which they invested.

may bring direct claims based on the theory that they were "induced to make and/or retain their investments.")

Similarly, Plaintiffs have standing to assert claims for breach of fiduciary duty.[61] To the extent that Defendants cite any authority to the contrary, those cases are distinguishable in that they involve shareholders suing the directors of the funds in which they invested, not shareholders suing third-party investment advisors or managers. Investment advisors – such as FGG – owe a fiduciary duty their investors, and those investors have standing to sue directly when that duty is breached. *See Rolf v. Blyth*, 570 F.2d 38, 45 (2d Cir. 1978) (*Rasmussen v. A.C.T. Envtl. Servs.*, 739 N.Y.S. 2d 220, 222 (App. Div. 2002). Indeed, even where shareholders sue the directors, as opposed to external investment advisors, courts have recognized those claims as direct. *See Fraternity Fund Ltd.*, 376 F. Supp. 2d 385 (shareholders in investment funds could bring claims for breach of fiduciary duty arising from overstating net asset values in reports to investors); *Higgins v. N.Y. Stock Exch., Inc.*, 806 N.Y.S.2d 339, 349 (Sup. Ct. 2005) (upholding breach of fiduciary claims as direct).

Furthermore, the Funds' claims are simply not the same as those of the investors who are putative class members. In the instant case, the Plaintiff class is comprised of investors who have suffered a loss on their investments in the Funds, measured on a "net equity" basis (total amount invested minus any amounts received in redemptions or "profit" distributions). In the case of the Funds, however, the net losses at the Fund level are necessarily much smaller than the aggregate net losses of the Plaintiff class, because many investors were "net winners" on a net

[61] The below argument relates largely to those Plaintiffs who invested in Fairfield Sentry or Fairfield Sigma. Defendants cannot possibly challenge the standing of those Plaintiffs who were limited partners in Greenwich Sentry Partners, L.P. or Greenwich Sentry, L.P. The agreements governing those investments recognize that, in the event a fiduciary duty is breached, a limited partner "may seek legal relief . . . for itself and other similarly situated Limited Partners or on behalf of the Partnership." See GS COM (Thorn Decl., Ex. 3, at 21); GSP COM (Thorn Decl., Ex. 4, at 20).

equity basis (and even though they may have continued to hold some Fund shares when the Madoff fraud was exposed). Judge Lifland's recent holding in the Madoff SIPA Liquidation explicitly recognizes this point, in adopting the Net Investment Method (*i.e.*, net equity) as the only fair way of determining losses and compensating investors in a Ponzi situation. This method "looks solely to deposits and withdraws that in reality occurred" to determine losses of each investor. *In re Bernard L. Madoff Investment Securities LLC*, No. 08-01789 (BRL) (Bankr. S.D.N.Y., Mar. 1, 2010). Accordingly, the losses that can be claimed here by the Fund entities will be far smaller than the aggregate losses of the Plaintiff class members who are asserting direct claims. These different positions entitle Plaintiffs to standing.

2. Independently, Plaintiffs Have Standing Because Fund Claims May Be Precluded by an *In Pari Delicto* Defense

Apart from any other basis for standing, Plaintiffs have standing to bring claims that would otherwise belong to the Funds because of the "Wagoner Rule." *See Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991). Under this rule, the corporation, and thus the trustee, standing in the shoes of that entity, cannot assert a claim where it was involved in the defendant's alleged wrongdoing. *Id.* In such instances, creditors or investors may assert claims that the corporation or trustee would be barred from bringing because of its own complicity in the wrongdoing. *See In re Hampton Hotel Investors L.P.*, 289 B.R. 563 (Bankr. S.D.N.Y. 2003). "A claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." Id. at 574 (*quoting Wright v. BankAmerica Corp.*, 219 F.3d 79, 86 (2d Cir. 2000). Indeed, the Second Circuit has explicitly held that claims arising out of a Ponzi scheme can only be asserted by the investors, not by the debtor's trustee. *See Hirsh v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093-1095 (2d Cir. 1995) (trustee of debtor which perpetrated a Ponzi scheme lacked standing to sue the debtor's former

accountants, for assisting in the fraud.) It is particularly appropriate to grant standing to investors in Ponzi schemes because the investment vehicle – or the trustee – may be subject to an *in pari delicto* defense. *See, e.g., E.F. Hutton & Co. v. Hadley*, 901 F.2d 979, 986-87 (11th Cir. 1990) (claims arising from Ponzi scheme belonged only to defrauded investors as trustee lacked standing); *Williams v. Calif. 1st Bank*, 859 F.2d 664, 667 (9th Cir. 1988) (same).

3. Plaintiffs Have Standing Even if Delaware and BVI Law Were Applied

To the extent Delaware law were held to govern the Greenwich Sentry Partnerships, the same outcomes would arise. *See, e.g., Albert v. Alex. Brown Mgmt. Servs.*, 2005 WL 2130607 (Del. Ch. Aug. 26, 2005) (claims of breach of fiduciary duty and fraud are direct); *FS Parallel Fund L.P. v. Ergen*, 2004 WL 3048751, at *3 (Del.Ch. 2004) (fraud claim is inherently direct). Defendants' argument to the contrary is based largely on the now disfavored special injury requirement, which the Delaware Supreme Court explicitly rejected in *Tooley v. Donaldson, Lufkin, & Jennette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004) ("We now disapprove the use of the concept of 'special injury' as a tool in that analysis.") After *Tooley*, there is no requirement that a shareholder allege a special injury, distinct from injury to the other shareholders. Instead, shareholders have standing if they suffered the alleged harm and would receive the benefit of a recovery – exactly the situation here. Moreover, Delaware courts have discarded the direct/derivative test entirely where the imposition of such formalistic requirements could work inequitable results – as it would here. *See Shamrock Holdings v. Arenson*, 456 F. Supp. 2d 599, 607 (D. Del. 2006) (traditional direct/derivative analysis does not apply where classifying the claim as derivative would allow culpable parties to partake in the recovery).

Likewise, English or BVI law also recognizes that shareholders in a corporation or partnership may pursue claims for fraud or misrepresentation, characterized as claims for deceit.

Miles Aff., ¶ 9.[62] Under BVI law, the investors would be able to recover the losses flowing from the wrong, including losses stemming from being fraudulently induced to purchase and retain the shares. Miles Aff., ¶¶ 9, 10.[63]

Although it is the case that BVI law, as derived from English law, would apply a doctrine of "reflective loss" that denies standing to investors if the loss in value of their shares merely "reflects" losses recoverable by the company. However, this principle applies only where the losses suffered by the shareholders "are the same as, and for the same amount as, those suffered by and recoverable by [the company]." Miles Aff. ¶ 15, discussing *Johnson v. Gore Wood* [2002] 2 AC 1. Here, that is not the case because, first, the funds do not have claims for fraudulent inducement or misrepresentation. *See* Miles Aff., ¶ 23 ("This claim for fraudulent misrepresentation is one which can only belong to the Plaintiffs as the parties to whom the misrepresentations are alleged to have been made."). Second, the Funds may not be able to recover on other claims because of the *in pari delicto* defense. *See* Hunte Aff., ¶ 23 ("If a company were barred from bringing claims on its own behalf, the reflective loss rule would not bar the shareholders from bringing such claims on their own behalf.").

Moreover, the Funds' claims are not the same as those of the investors. The funds, even if they have viable claims, are seeking recovery for fund investments that have been reduced by the amounts withdrawn by shareholders who have redeemed principal and, often along with the

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[62] Plaintiffs have submitted the affidavit of Robert Miles, Q.C. ("Miles Aff.") and Lewis Hunte, Q.C. ("Hunte Aff.") on BVI law. Mr. Miles sets forth the principles of BVI law applicable here, whereas defendants affidavits improperly seek to present the conclusion that Plaintiffs' claims would be "struck out" by a BVI court.

[63] As Mr. Miles notes, Defendants conflate claims of mismanagement with claims stemming from being fraudulently induced to purchase or hold shares. See Miles Aff., ¶¶ 25. "Further, in so far [defendants' expert] characterizes the Plaintiffs' claims as being for mismanagement of the Funds he does not separately address what appears to be an essential aspect of the Complaint, namely, that the Plaintiffs were fraudulently induced to become and remain investors."

principal, substantial profits. The Madoff trustee has alleged that these amount to billions of dollars. The investors' claims conversely are for a class comprised of investors who have lost all or part of their net equity invested. *See* Miles Aff., ¶ 29. As Mr. Miles notes, an English or BVI court would not dismiss an otherwise valid claim unless it was clearly established that the loss was entirely reflective. Miles Aff., ¶ 20 (a U.K. Court will be especially cautious of striking out a claim in an area of developing jurisprudence because in such areas decisions on novel point of law should be decided on real rather than assumed facts); Hunte Aff., ¶ 22 (A BVI court will not strike out a claim "where the argument involves a substantial point of law which does not admit of a plain and obvious answer; or the law is in a state of development, or where the strength of the case may not be clear because it has not been fully investigated.").

III. PLAINTIFFS PROPERLY ALLEGE CONTRACT-RELATED CLAIMS

Plaintiffs adequately allege contract and quasi-contract claims. Although Defendants seek to advance a blanket rule that investors cannot pursue contract-based claims against third parties, no such rule exists. Instead, Plaintiffs' claims turn on the specific nature of the contracts in question and relevant evidence relating to those contracts.

A. Plaintiffs State a Claim for Third-Party Beneficiary Breach of Contract Against FG and Fee Defendants

Plaintiffs' claims for third-party breach of contract are governed by the liberal notice pleading standards of Fed. R. Civ. Pro. 8(a). *Caudle v. Tower, Perrin, Forster & Crosby, Inc.*, 580 F. Supp. 2d 273, 284 (S.D.N.Y. 2008). The SCAC merely has to allege facts "sufficient 'to raise a right to relief above the speculative level.'" *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007) (*quoting Twombly*, 127 S. Ct. at 1965). Even without the benefit of discovery, the SCAC adequately pleads facts that would support plaintiffs' claims to be

intended third party beneficiaries of the IMAs between the Funds and FGBL.[64] Furthermore, the determination of "third-party beneficiary status is a question of fact." *Debary v. Harrah's Operating Co., Inc.*, 465 F. Supp. 2d 250, 261 (S.D.N.Y. 2006). Where there is any ambiguity in the contractual language, courts – even at summary judgment – typically refuse to decide the issue of whether the contract intended to confer third-party beneficiary status. *See, e.g., Barry v. Atkinson*, 2009 WL 255431 (S.D.N.Y. May 19, 1998).

1. The Bermuda Choice of Law Provisions in the IMAs are Unenforceable

Although the IMAs contain choice of law provisions designating Bermuda law, enforcement of the provisions under the circumstances in this case would serve to further Defendants' fraud – a recognized exception to the deference usually given to contractual choice of law provisions. *See Marine Midland Bank, N.A. v. United Mo. Bank, N.A.*, 643 N.Y.S.2d 528, 531 (App. Div. 1996).

Further, a choice of law provision is invalid "where the issue is of such overriding concern to the public policy of the other jurisdiction as to override the intent of the parties and the interest of this State in enforcing its own policies." *Id.* at 531. Because New York common law generally recognizes third-party beneficiary rights of action, application of the Bermuda choice of law provision should be rejected as violative of New York's judicially-expressed public policy.

2. The Parties Intended to Benefit the Funds' Investors as Third-Party Beneficiaries

New York has adopted the Restatement (Second) of Contracts §302 (1981) which sets forth the elements of a third party breach of contract claim. *Fourth Ocean Putnam Corp. v.*

[64] Those Plaintiffs who were investors in Greenwich Sentry, L.P. and Greenwich Sentry Partners, L.P. do not press third party beneficiary claims. Instead, they assert claims for mutual mistake. *See* Section III. C, below.

Interstate Wrecking Co., Inc., 66 N.Y.2d 38, 44 (1985). Under the Restatement, a party will be deemed an intended beneficiary with rights to enforce a contract if "recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and . . . b) the circumstances indicate that the promisee intends to give the benefit of the promised performance." *Id.* at 44. The promise to benefit the third party does not have to be expressly stated in the contract. *Trans-Orient Marine Corp. v. Star Trading & Marine, Inc.*, 925 F.2d 566, 573 (2d Cir. 1991) ("In determining third party beneficiary status it is permissible for the court to look at the surrounding circumstances as well as the agreement. . . . [i]t is well-settled that the obligation to perform to the third party beneficiary need not be expressly stated in the contract.").

Here, the circumstances indicate that the IMAs intend to give the benefit of the promised performance to Plaintiff investors. The IMAs entered into between the Funds and the investment managers outline the nature of the Investment Managers' obligations. The IMAs and the PPM dated October 1, 2004, must be read together because the IMAs state that "[t]he Fund hereby retains the Investment Manager to manage the investment of its assets *as contemplated by and described in* the Confidential Private Placement Memorandum of the Fund, dated October 1, 2004 . . .) (emphasis added.) The IMAs incorporate the PPM by reference.

The PPMs set forth the understanding that the Investment Managers would be providing management services that would benefit the shareholders of the Funds. *See, e.g.*, Thorne Decl. Ex. 1, FS PPM 8/14/06 at 7 ("The Investment Manager") and at 9 ("Investment Policies").

The surrounding circumstances reinforce the conclusion that the Funds intended to make investors beneficiaries of the agreements. The court can look at the reasons why the Funds retained the Investment Managers and the course of performance as indications of the parties' intent.

3. The Exculpation Clause in the IMAs Does Not Relieve Defendants of Liability

The purported "exculpatory" provisions in the IMAs between the Funds and their investment managers do not have any impact on Plaintiffs' direct claims against Defendants. Again, Plaintiffs' action is a class action, not a derivative one. The provisions do not address, or even mention losses that are suffered by third-parties, such as Plaintiffs. *See, e.g.*, Thorne Decl. Ex. 1.

Further, even if the scope of the clause covered Plaintiffs' claims, Plaintiffs allege conduct by FG Defendants that falls outside the scope of the exculpatory clauses. *See* SCAC ¶¶ 181-249.

B. Plaintiffs Properly Plead Unjust Enrichment

Alternatively, Plaintiffs have standing to assert claims for unjust enrichment based on the hundreds of millions of dollars in fees that FGG collected for purportedly managing fictitious assets. While defendants argue that such claims are barred by the IMA contracts, they ignore that the Federal Rules of Civil Procedure permit pleading alternative, and even inconsistent, theories. *See* Fed. R. Civ. P. 8(d)(2); *Riverwoods Chappaqua Corp. v. Marine Midland Bank*, N.A., 30 F.3d 339, 343 (2d Cir.1994) (discussing Rule 8(d)(2)).

Recovery on an unjust enrichment theory is not precluded where the contract in question is unenforceable or invalid. *See Seippel v. Jenkens & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 381 (S.D.N.Y. 2004); *Gordon v. Oster*, 829 N.Y.S.2d 49, 50 (App. Div. 2007) ("Inasmuch as plaintiffs' allegations present a bona fide question as to whether the parties' agreement was valid and enforceable, or was instead procured by fraud, the unjust enrichment claim should have been permitted."). Here, Plaintiffs present a bona fide question whether the IMAs and the Greenwich

Sentry and Greenwich Sentry Partners partnership agreements ("LPAs") were "valid and enforceable."

The SCAC alleges that the IMAs and LPAs provided "management" and "performance" based compensation to the FGG Defendants that was grossly disproportionate to the work performed by the FGG Defendants – both because the FGG Defendants were not investment advisors, but at most were only placement agents performing due diligence on Madoff, and because the FGG Defendants did not even conduct the due diligence that they had contracted for under the IMAs and LPAs. *See* SCAC ¶¶ 4, 236, 239, 241, 242, 246, 248, 413. The gross overpayment of fees to the FGG Defendants for work they did not perform makes the IMAs and LPAs without more unconscionable and invalid. *See U.S. Underwriters Ins. Co. v. Landau*, 2010 WL 173301, at *8 (E.D.N.Y. 2010), *quoting Rosenfeld & Quality Frozen Foods. Inc. v. Port Auth. of N.Y. & N.J.*, 108 F. Supp.2d 156, 164 (E.D.N.Y. 2000) ("Substantive unconscionability requires a determination whether 'the terms were unreasonably favorable to the party against whom unconscionability is urged.'").[65]

Based on Plaintiffs allegations, the elements of an unjust enrichment claim are satisfied. "To state a claim for unjust enrichment in New York, a plaintiff must allege that: (1) the defendant was enriched; (2) the enrichment was at plaintiff's expense; and (3) the circumstances were such that equity and good conscience require defendant to make restitution." *Intellectual Capital Partner v. Inst. Credit Partners LLC*, 2009 WL 1974392, at *8 (S.D.N.Y. July 8, 2009).

[65] The unenforceability of the IMAs is also corroborated by Plaintiffs' continuing investigation. *See* Finkel Decl. ¶¶ 25-31, indicating that directors with conflicts of interest approved the IMAs, thereby making them voidable under BVI law. *See* BVI Companies Act (2004) at 124, 125. Of the three directors on the Sentry and Sigma Funds' Boards, Director Walter Noel was the founder and second-largest equity participant in FGG. Director Peter Schmid was an investment advisor who sold investments in FGG funds to his client and received kickbacks from FGG of 30% of performance fee that FGBL earned under IMAs. Schmid was also partners with FGG's largest shareholder, Andreas Piedrahita, in a Brazilian investment fund and had discussed becoming a partner in FGG.

Unjust enrichment does not require a direct relationship between the parties. *See In re Canon Cameras Litig.*, 2006 WL1751245, at *2 (S.D.N.Y. June 23, 2006), and *Cox v. Microsoft Corp.*, 778 N.Y.S. 2d 147, 148-149 (App. Div. 2004) (App. Div. 2004).

The Complaint alleges that "defendants wrongfully collected hundreds of millions of dollars in unearned fees based on the fictitious assets supposedly managed by, and profits supposedly generated by, Madoff for FGG's investors." SCAC ¶ 4. Defendants collected these fees in the form of placement fees, performance fees, management fees, fees for administrative services and back office support, and incentive or performance fees. SCAC ¶¶ 236-249. These fees were unearned because they were "calculated on the basis of non-existent profits and asset values that were reported by Madoff." SCAC ¶ 236. Based on the gross failures by the Defendants – and the fees, salaries and bonuses those Defendants received despite those failures – Plaintiffs most certainly did not receive "what they paid for." Accordingly, Plaintiffs have adequately pled a claim. *See, e.g., Intellectual Capital Partner v. Institutional Credit Partners LLC*, 2009 WL 1974392, at *8-9 (S.D.N.Y. July 8, 2009); *Space, Inc. v. Simowitz*, 2008 WL 2676359, at *3 (S.D.N.Y. July 7, 2008); *Cruz v. McAneney*, 816 N.Y.S.2d 486, 490-491 (App. Div. 2006).

The cases cited by Defendants are distinguishable because the relevant conduct in those cases was governed entirely by undisputed written agreements. *Goldman v. Metro. Life Ins. Co.*, 807 N.Y.S. 2d 583, 587-88 (2005) ("the disputed terms and conditions fall entirely within the insurance contract."); *Clark-Fitzpatrick, Inc. v. Long Island R. R. Co.*, 70 N.Y.2d 382, 389 (1987); *Metro Elec. Mfg. Co. v. Herbert Constr. Co.*, 583 N.Y.S. 2d 497, 498 (App. Div. 1992). In the present case, Defendants not only dispute which agreements, if any, apply to the relationships among the parties, but they also dispute that Plaintiffs and certain defendants were

parties to certain agreements. *See e.g.* FG Br. at 71 (". . . even if Plaintiffs had identified the correct agreements – the IMAs and LPAs . . . . Plaintiffs have no basis to rescind the IMAs because neither they nor any FG Defendant except for FGL, and then FGBL, were parties to the IMAs . . . .") The significant disputes surrounding the relevant agreements preclude dismissal of Plaintiffs' unjust enrichment claims.

Finally, Plaintiffs' claims should not be dismissed because it is too early at this procedural stage to assess whether unjust enrichment is an appropriate remedy. *Russo v. Mass. Mut. Life Ins. Co.*, 1997 N.Y. Misc. LEXIS 170 at *7 (N.Y. Sup. Ct. Mar. 25, 1997) ("[W]hether an injustice occurred which resulted in an enrichment of the defendant must await trial of the fraud-related causes of action. The remedy, if any, may never involve the imposition of a trust and we see no reason why the Court should be compelled to dispose of these issues, as a matter of law, when no discovery has occurred and the nature of any final outcome, not to mention the nature of any remedies, is far from clear.") *See also Ambac Assurance Corp. v. EMC Mortgage Corp.*, 2009 WL 734073, at *1 (S.D.N.Y. Mar. 16, 2009) (denying a motion to strike [under Fed. R. Civ. P. 12(f)] Plaintiff's request for rescissory damages under New York law "'because the relief provided for [Plaintiffs] claims will be determined if any entitlement to remedies is proved.'" (citations omitted)); *Owens v. Hous. Auth. of Stamford*, 394 F. Supp. 1267, 1274 (D. Conn. 1975) (motion to dismiss a request for relief should be denied as "the propriety of the redress requested must, of course, await more advanced steps in this litigation.").

C. Plaintiffs Properly Allege a Claim of Mutual Mistake

Those Plaintiffs who were limited partners in Greenwich Sentry, L.P., or Greenwich Sentry Partners, L.P. – and therefore parties to the PAs for those entities – adequately allege claims of mutual mistake. It is well established that a party may void a contract based on mutual mistake where the mistake concerns a basic assumption of the contract, and materially affects the

agreement. *Gould v. Board of Educ. of Sewanhaka Cent. High School Dist.*, 81 NY2d 446 (1993). "The 'mutual mistake' must be as to the very nature of the subject sold . . . for example, where what both parties believed to be a barren cow turns out to be with calf." *In re Leslie Fay Cos., Inc. Sec. Litig.*, 918 F. Supp. 749 (S.D.N.Y.1996) (citing *Sherwood v. Walker*, 66 Mich. 568, 33 N.W. 918 (1887)). Here, Plaintiffs' entire investment in the Greenwich Sentry Partnerships was predicated on the fundamental assumption that the Partnerships were participating in a "specialized investment program" consisting of the "split strike conversion strategy" as implemented by Madoff. In reality, however, there was neither a specialized investment program, nor any investment strategy. Simply put, there were no investments at all.[66] This mistake indisputably goes to the basic subject matter of the exchange, and the essential terms of the agreements, rendering them voidable. *See The Indep. Order of Foresters v. Donaldson, Lufkin & Jenrette Inc.*, 1997 WL 563348, *7 (S.D.N.Y. Sept. 9, 1997) (distinguishing between mistake in valuation of securities and mistake as to the very subject matter of the exchange); *In re Leslie Fay*, 918 F. Supp. at 770 (same). If, as Defendants assert, they had no knowledge of Madoff's fraudulent scheme, and are therefore able to escape liability for fraud, then the Greenwich Sentry Partnership Agreements were entered into under a mutual mistake of fact regarding a basic assumption: that Madoff was actually engaged in any trading activity whatever. As a result, Plaintiffs are entitled to recover any fees paid pursuant to those agreements, including management and performance fees that were collected from each limited partner's account. *See* GS COM, Thorn Decl., Ex. 3, at 3; GSP COM, Thorn Decl., Ex. 4, at 3.

[66] Plaintiffs' claim in this regard is far different from alleging an error as to the value of the investments in question, which is not asserted as a basis for the mistake claim.

IV. FGG IS A PARTNERSHIP PROPERLY NAMED AS A DEFENDANT

Plaintiffs name as a defendant the Fairfield Greenwich Group – FGG – as a partnership comprised of corporate Fairfield Greenwich entities and individual defendants. (SCAC ¶ 117.) ("The FGG partners intended to act as partners, held themselves out to Plaintiffs and other investors as partners, and conducted business under the name Fairfield Greenwich Group without regard to corporate structure and formalities."); (SCAC ¶¶ 118-45, 168-69, 176-80) (individual and corporate defendants' participation in the partnership). The Complaint thus includes FGG as among the "Fairfield Fraud Claim Defendants" (SCAC ¶ 151) against whom claims are asserted in Counts 1-11.

Defendants contend that FGG is not a legal entity subject to suit. *See* FG Br. at 26-29; Fee Def. Br. at 14-16. At the very least, however, in the Complaint sufficiently alleges in the above-cited paragraphs that defendants held FGG out as a legal entity and there are questions of fact as to FGG's existence as a partnership that preclude dismissal prior to discovery.

For example, an FGG brochure attributes the activities of its "Partners" to FGG, stating: "Under the leadership of its Partners, FGG has built a team of professionals who specialize in product development, risk management, marketing, operations, compliance, and client services on a global basis." (SCAC ¶ 179.)

Defendants go outside the Complaint and argue that the PPMs and COMs provided to investors "clearly set forth the corporate status of the FG Defendant entities." FG Br. at 27, *quoting, e.g.*, 8/14/06 Sentry PPM (Ex. 1) at 2; Form ADV Part II, Page 5.[67] However, the 8/14/06 PPM (SCAC ¶ 195) itself refers to FGG in language that a jury could find establishes a partnership:

[67] Defendants argue that Plaintiffs may not rely on a brochure to allege that FGG is a partnership. *See* FG Br. at 29. While such brochures were given to Plaintiffs to induce them to invest, as noted above, similar statements are also made in the private placement memoranda on which Defendants rely.

> FGBL and FGL are member companies of the Fairfield Greenwich Group ("FGG"), which was established in 1983 and had, as of May 1, 2006, more than $9.0 billion employed in alternative management funds. Throughout its history, FGG has internally managed its own alternative asset funds and selectively identified external managers for affiliations where it serves as a managerial and distribution partner. [Ex. 1 at 7.]

Indeed, the 8/14/06 PPM references FGG as an entity no fewer than thirty-three times. *See* Thorne Decl. Ex. 1 at 2, 6, 7, 8, and Schedule F.

Similarly, the 12/1/08 Sigma PPM (Thorne Decl. Ex. 2; FG Br. at 27 n. 29), rather than highlighting separate corporate entities, references "the founders, principal officers and certain other key employees of FGG and affiliates." For example, defendant Noel is described as a "Non-executive Director [who] co-founded FGG in 1982" (Thorne Decl. Ex. 2 at 6). Defendants Piedrahita, Tucker, Landsberger, McKeefrey, Murphy, Smith and Toub are all listed as directors, non-executive directors, or holding other offices of FGG. *Id.* at 7-8. In total, the 12/1/08 Sigma PPM references FGG, Fairfield Greenwich Group, or the FGG Funds fifty-two times. *See* Thorne Decl., Ex. 2. Similarly, other documents cited by Defendants (*see* FG Br. at 27 n. 29) also identify FGG as an actual, integral entity in Defendants' business operations. *See, e.g.*, Thorne Decl. Ex. 12 at 7 (identifying FGG as an "affiliate" of the manager); Ex. 3 at 9 (identifying FGG as an "affiliate" of the General Partner). By contrast, there is a total absence in any of Defendants' statements to investors of any statement that FGG is not a legal entity.

Moreover, the Complaint alleges facts which show that the FGG partners met the legal standards for recognition as a partnership. *See, e.g., Kidz Cloz, Inc. v. Officially For Kids, Inc.*, 320 F. Supp. 2d 164, 171 (S.D.N.Y. 2004) (cited in FG Br. at 27): "[C]ourts consider whether the alleged partners":

1. "[S]hared profits and losses" – they did.[68]

2. "[J]ointly controlled the management of the business" – they did. (SCAC ¶¶ 177, 179.)

3. "[C]ontributed property, financial resources, effort, skill or knowledge" – they did. (SCAC ¶¶ 117-145, 148, 177-180.)

4. "[I]ntended to be part of a legal partnership" – they did. (SCAC ¶¶ 117-145, 148, 177-180.)

Thus, sufficient facts are alleged in the Complaint to justify treating FGG as an actual or de facto partnership entity. *See, e.g., In re Cross Media Mktg. Corp.*, 367 B.R. 435, 455-56 (Bankr. S.D.N.Y. 2007) (finding that defendants "formed and functioned as a partnership" on the basis of such factors as conduct of regular meetings to discuss the business affairs of the partnership; contribution of property, financial resources, effort, skill, or knowledge of the business; and an agreement to share the profits among the partners – facts all present here); *Olson v. Smithtown Med. Specialists, P.C.*, 602 N.Y.S.2d 649 (App. Div. 1993) ("The issue of whether a partnership . . . exists is a question of fact [citations omitted]. If an individual receives a share of the profits of a business, it is prima facie evidence that he is a partner in the business, as long as these profits were not received by an employee as wage payments (*see,* Partnership Law § 11[4][b])."). [69]

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[68] The evidence that Defendants pooled and distributed profits and losses includes SCAC ¶ 148 (citing Ex. 61 in the Massachusetts Proceeding, "Partner Compensation Spreadsheet," an FGG chart naming the Individual Defendants and showing their percentage interests in FGG's profits which appears in full as Ex 2 to the Finkel Decl.). *See also* SCAC ¶ 177; Massachusetts Proceeding, Ex. 58 (wiring McKeefrey $1.5 million as a "return of capital"); Ex. 59 (approving "an advance" on Harary's "capital account").

[69] The cases upon which defendants rely (FG Br. at 27-28) do not support their position. For example, in *Kidz Cloz* the court found on summary judgment that the parties only had preparatory conversations and never reached an agreement, *see* 320 F. Supp. 2d at 172-75; there were no allegations (as there are here) that the parties held themselves out to the world as an existing partnership. *See also Kosower v. Gutowitz*, 2001 WL 1488440, at *5-6 (S.D.N.Y. Nov. 21, 2001) (finding "no meeting of the minds" with respect to a joint venture); *N. Am. Knitting Mills, Inc. v. Int'l Women's Apparel, Inc.*, 2000 WL 1290608 (S.D.N.Y. Sept. 12, 2000) (no allegations of actual partnership). Similarly, Defendants' citations concerning the doctrine of "partnership by estoppel" (*see* FG Br. at 28) are inapposite because they involved circumstances where it was proven (or acknowledged) that no actual partnership existed – exactly the opposite of the situation here.

V. PLAINTIFFS' CLAIMS ARE NOT BARRED BY THE EXCULPATORY PROVISIONS IN THE FAIRFIELD SENTRY AND FAIRFIELD SIGMA INVESTMENT MANAGEMENT AGREEMENTS

The exculpatory provision in §10 of the Investment Management Agreements by and between the Funds and FGBL[70] purporting to exonerate FGBL from liability for any act or omission except those that constitute "willful misconduct, bad faith or reckless negligence"[71] does not preclude the state law claims asserted in the SCAC against the Fairfield Defendants for four independent reasons: (1) the Bermuda Supply of Services (Implied Terms) Act 2003 invalidates any provision in a contract for the supply of services that purports to excuse a supplier from a duty of reasonable care and skill, (2) the Plaintiffs are not parties to the IMAs, and, therefore, are not bound by the contractual exculpatory provisions therein, (3) the direct tort claims against the Fairfield Defendants are not subject to the exculpatory provisions to the extent these claims are not contractually based or seek to recover damages inflicted on the shareholders, not losses of the Funds, and (4) Plaintiffs' claims against the Fairfield Defendants based on fraud (Counts 1 and 2), negligent misrepresentation (Counts 5 and 6), and gross negligence (Count 7) are beyond the scope of the exculpatory provision. Moreover, the Fairfield Defendants' attempts to assert the exculpatory provision in favor of persons or entities other than FGBL (e.g., FRS) or its officers and directors, as alleged agents of FGBL, raise factual issues that cannot be resolved on a motion to dismiss. The Fairfield Defendants have not provided a competent factual basis

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[70] Copies of the IMAs between FGBL and the Fairfield Sentry Fund, both dated October 1, 2004, are appended to the Thorne Decl. as Exs. 5 and 6.

[71] Section 10(b) of the FGBL IMAs further purports to require the Funds to exonerate and indemnify FGBL, its directors, officers and employees, agents and counsel from liability "except to the extent that such act or omission constitutes willful misconduct or reckless disregard of the duties of the Investment Manger or on the part of the Investment Manager Indemnitee."

for such claims in any event.[72]

A. The Bermuda Supply of Services (Implied Terms) Act 2003 Invalidates the Exculpatory Provisions

The IMAs expressly provide that they are to be governed by Bermuda law (IMA §15)(copies of the FGBL IMAs are appended to the Thorne Decl., Exs. 5 and 6). The Bermuda Supply of Services (Implied Terms) Act 2003 provides in pertinent part:

> 3. **Implied term about care and skill**
>
> In a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill.
>
> 6. **Contracting out**
>
> The terms implied by this Act in a contract for the supply of a service shall have the effect notwithstanding any agreement, course of dealing between the parties or usage.

The IMAs are service contracts. The "whereas" clauses of the IMAs with FGBL recite that the Funds "[wish] to obtain the investment management services of the Investment Manager" and the Investment Manager (FGBL) "is willing to provide such advice and services." Accordingly, the exculpatory provision is of no force and effect to the extent that it purports to

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[72] FGL was the investment manager of the Fairfield Sentry Fund until 2003 pursuant to an IMA dated October 1, 2002 (SCAC ¶ 118, Thorne Decl. Ex. 9). The FGL IMA was expressly governed by New York law (Thorne Decl. Ex. 9, ¶ 14). Under New York law, concurrent liability may arise in tort and contract. *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540 (1992). Contractual limitations against claims based on a party's own negligence are enforceable, but a party may not exonerate itself against damages caused by intentional wrongdoing, gross negligence or conduct exhibiting a reckless indifference to the rights of others however denominated. *Id.* at 540. Distinguishing between ordinary negligence and gross negligence is for the trier of fact to determine. Contractual exculpation clauses are inapplicable where the party seeking damages is not a party to the contract or the actions giving rise to the liability are premised on facts separate from a breach of contract claim. The Plaintiffs were not parties to the IMAs with FGL. Moreover, the claims in the SCAC against the Fairfield Defendants are based on conduct that was intentional, grossly negligent, and/or recklessly indifferent to Plaintiffs' rights. Gross negligence is "conduct that evinces a reckless disregard for the rights of others or 'smacks' of intentional wrongdoing." *AT&T v. City of New York*, 83 F.3d 549, 556 (2d Cir. 1996), citing *Colnaghi, U.S.A. Ltd. v. Jewelers Protection Serv., Ltd.*, 595 N.Y.S. 2d 381, 383 (1993). Consequently, the exculpatory provision is ineffective to defeat such claims for the reasons set forth above.

exempt FGBL and others from a duty of due care (Affidavit of Mark Diel, Q.C. ("Diel Aff.") at ¶¶ 29-31).

B. Plaintiffs' Claims Are Not Limited by the Exculpation Clauses

The Plaintiffs are not parties to the IMAs, and therefore, cannot be bound by the exculpatory provisions of the IMAs as a matter of Bermuda law to the extent that they assert claims that are independent of the contract between the Funds and FGBL (Diel Aff. at ¶ 27). The Fairfield Defendants contend that the inclusion of a description of the exculpation provision in the Funds' PPMs somehow makes the shareholders party to the IMA or bound by its terms (FG Br. at 25). This is not the case. At most, the reference to the arrangement between the Funds and their investment advisor was a necessary disclosure concerning the terms of a material contract, but did not make the shareholders a party to the IMAs or bind them to the terms of the exculpatory provision contained therein. PPMs are merely disclosure documents summarizing the terms of the IMAs, not a bilateral agreement entered into by the investors with the Investment Advisor.

The Fairfield Defendants contend that FGBL did not owe a duty to the shareholders under the IMAs so the concepts of willful misconduct, willful malfeasance, gross negligence, reckless disregard, and bad faith do not come into play (FG Br. at 26). The exculpation provision does not apply for other reasons, but the premise that FGBL owes no duties to the shareholders is dead wrong. FGBL and the other Fairfield Defendants owed duties to the shareholders under Bermuda law that are not rooted in the IMAs. Bermuda law imposes a fiduciary duty on investment managers where, as here, they are entrusted with funds by investors. Diel Aff. ¶¶ 12-17. This duty is extra-contractual.

The Fairfield Defendants also incurred a separate duty to Plaintiffs by making false or negligent misrepresentations to Plaintiffs with the intention that they should rely thereon. Miles

Aff. ¶¶ 43-5, 48-50; Diel Aff. ¶¶ 18, 29. These claims cannot be avoided by the exculpatory provisions in the IMAs purporting to limit FGBL's exposure to contractual claims or concurrent obligations in tort pendent to the contract.

The SCAC does not assert derivative claims on behalf of the Funds to enforce rights under the IMAs. Thus, the issue of contractual limitations on concurrent tort liabilities arising out of or related to the IMAs simply does not arise (*id.* ¶ 21). Plaintiffs' claims are direct claims based on misrepresentations made by the Fairfield Defendants to investors and/or the breach of fiduciary duties owed to investors who entrusted funds to the Fairfield Defendants for investment (Diel Aff. ¶¶ 12-18 and *Horizon Bank Int'l Ltd. v. A. Walsh et al.*, [2009] CA (Bda) 6 Civ (March 2009)).

C. The Claims against the Fairfield Defendants Are Beyond the Scope of the Exculpation

The SCAC alleges conduct by FGBL and other FG Defendants that is not exonerated by the terms of the exculpatory provision. The exculpatory provision purports to limit liability "except to the extent such an act or an omission constitutes willful misconduct, or reckless disregard of the duties" of the Investment Manager or of an Investment Manager Indemnitee. (Thorne Decl. Exs. 5, 6 and 9 at §10). Contractual provisions purporting to limit liability are construed narrowly against the party seeking to invoke the provision. *Healthextras, Inc. v. SG Cowen Sec. Corp.*, 2004 WL 97699 (S.D.N.Y. Jan. 20, 2004), citing *Zoller v. Niagara Mohawk Power Corp.*, 525 N.Y.S. 2d 364, 367 (App. Div. 1989) ("[E]xculpatory clauses should be strictly construed against the person seeking exemption from liability.").

Plaintiffs' claims for fraud (Counts 1 and 2), negligent misrepresentation (Counts 5 and 6), gross negligence (Count 7) and third-party beneficiary (Count 8) are beyond the scope of the exculpatory provision (Miles Aff. ¶ 46). Where as here, the Fairfield Defendants failed to

conduct any due diligence into Madoff's operations and ignored an abundance of red flags indicating that Madoff's operation was fraudulent, this constitutes willful misconduct and reckless disregard under Bermuda law (Diel Aff. ¶ 36). Similarly, the Fairfield Defendants' breach of their fiduciary duties (Count 8) owed to the shareholders was intentional and flagrant, not merely thoughtless or careless.

D. The Extent to which FGG Defendants other than FGBL Can Invoke the Exculpation Provisions Raises Issues of Fact

Defendants contend that other unidentified FGG Defendants are protected by the exculpatory provisions as agents of FGBL. Their brief contains no hint as to who these defendants might be or how they came to be agents of FGBL. The issue of whether one party is an agent of another for purposes of the exculpation provision raises issues of fact. In the absence of any supporting detail, a Bermuda Court would not strike out a claim because the argument raises issue of fact as to the existence of agency (Diel Aff. ¶ 22). *See also Gold Connection Discount Jewelers, Inc. v. Am. Dist. Tel. Co., Inc.*, 622 N.Y.S.2d 740 (App. Div. 1995) (motion to dismiss breach of contact and negligence claims pursuant to exculpatory provision purporting to limit liability to gross negligence denied because defense raised "triable issues of fact."). Moreover, even assuming *arguendo* that some of the directors and officers of FGBL might be entitled to invoke the exculpatory provision, the contractual limitation would not shield them from claims brought against them in other capacities.

VI. PLAINTIFFS' STATE LAW CLAIMS ARE NOT PREEMPTED

Invoking SLUSA and New York's Martin Act, Defendants argue that the only claim that plaintiffs can possibly pursue is a Rule 10b-5 fraud action under federal securities law. And since Defendants further argue that the 10b-5 claim is defective under the PSLRA (though as shown above, it is not), Defendants conclude that the SCAC contains no viable claims. Yet,

given the undisputed facts showing Defendants' role in financing the greatest fraud in financial history, such an outcome would fly in the face of common sense and fundamental fairness. Given the magnitude and public importance of the Madoff fraud, the Court should not preempt Plaintiffs' claims in the absence of clear and binding authority which compels only that result. As shown below, no such authority exists, while the law supports Plaintiffs' right to pursue these claims.

A. SLUSA Does Not Preempt Plaintiffs' Common Law Claims

Defendants' claim that "[a]ll Plaintiffs' claims except for securities fraud are . . . preempted by SLUSA" (FG Br. at 20), rests on the following statutory language:

> "No covered class action based upon the statutory or common law of any State . . . may be maintained in any State or Federal court by any private party alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security."

Securities Act of 1933 (15 U.S.C. § 77p(b)(1). While this case is a "covered class action," the securities at issue are not "covered securities," nor have Plaintiffs alleged any fraud "in connection with the purchase or sale of a covered security."[73]

Defendants present a hodge-podge of inapposite citations to cases in which the factual circumstances are readily distinguishable from the present case. In each case cited, the court determined that the core of the claim involved plaintiffs' direct purchase or sale of a covered

[73] SLUSA must be interpreted in light of its "very narrow" purpose. *See* Remarks of Sen. Dodd, sponsor of SLUSA, 144 Cong. Rec. 1998 WL 243654 (daily ed. May 13, 1998) (Statement of Sen. Dodd). SLUSA's sole intent was to close a perceived "loophole" that allowed securities fraud cases to be filed as state court class actions so as to avoid the heightened pleading requirements and limitations on early discovery under the PSLRA. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003). SLUSA was never intended to create new and significant incursions into areas traditionally reserved for longstanding common law remedies. "[B]ecause the States are independent sovereigns in our federal system, [courts] have long presumed that Congress does not cavalierly pre-empt state-law causes of action." *Medtronic, Inc. v. Lohr,* 518 U.S. 470, 485 (1996).

security, or a direct agreement to make such a purchase. *See* FG Br. at 20-22.[74] Here, by contrast, it is undisputed that the FGG Funds that Plaintiffs purchased are not "covered securities." Thus, while it is true that "Plaintiffs' state law claims for negligent misrepresentation and common law fraud" allege "a misrepresentation or omission" (FG Br. at 21), the SCAC makes such allegations only with respect to acquiring or holding interests in one of the FGG Funds, none of which are "covered securities." *See, e.g.*, SCAC ¶¶ 355, 357-58.

1. Plaintiffs Did Not Purchase "Covered Securities"

Under SLUSA, a "covered security" is limited to securities "listed . . . on the New York Stock Exchange or the American Stock Exchange, or . . . on the National Market System of the Nasdaq Stock Market." *See* 15 U.S.C. § 77r(b)(1)(A). Plaintiffs never purchased any such "covered securities." Rather, Plaintiffs' claims are based on their purchases of shares in Fairfield Sentry Limited and Fairfield Sigma Limited, both British Virgin Islands ("BVI") companies; and

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[74] In *Cinicolo v. Morgan Stanley Dean Witter & Co.*, 2004 WL 2848542 (S.D.N.Y. Dec. 9, 2004), plaintiffs bought and sold "covered securities" in connection with analyst misconduct. In *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003), plaintiffs purchased and held covered securities in an ERISA plan based upon inflated valuations of WorldCom shares. In *Winne v. Equitable Life Assurance Soc'y*, 315 F. Supp. 2d 404 (S.D.N.Y. 2003), plaintiffs alleged misrepresentations about the terms of an annuity that plaintiffs purchased that was found to be a covered security. In *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377 (E.D.N.Y. 2002), plaintiffs alleged misrepresentations involving their purchase of certain variable life insurance policies which were found to be covered securities. In *Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001), the court found that certain notes subject to a contract to repurchase qualified as "covered securities." In *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305 (6th Cir. 2009), plaintiff made common law claims regarding a trustee bank's decision to buy mutual fund shares which were covered securities. In *Dommert v. Raymond James Fin. Serv., Inc.*, WL 1018234, at *12 (E.D. Tex. Mar. 29, 2007), plaintiffs alleged wrongdoing regarding their agreement to purchase and sell covered securities. In *Schnorr v. Schubert*, 2005 WL 2019878 (W.D. Okla. Aug. 18, 2005), the court determined that plaintiffs actually purchased what they believed to be either covered securities or options to purchase covered securities based upon their reliance on defendant's misrepresentations. In *Disher v. Citigroup Global Mkts., Inc.*, 487 F. Supp. 2d 1009, 1012 (S.D. Ill. 2007), plaintiffs alleged that defendants issued misleading research on the value of covered securities which induced plaintiffs to hold such shares. In *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d 845, 871-72 (D. Md. 2005), plaintiffs claimed that late trading and market timing practices directly affected the value of covered securities. Thus, in every case cited by Defendants, there was either an actual covered securities transaction made directly by the plaintiffs or a contract by the plaintiffs to make a covered securities transaction.

of limited partnership interests in Greenwich Sentry, L.P. and Greenwich Sentry Partners, L.P., which are Delaware limited partnerships. SCAC ¶¶ 170-73. None of these securities were ever traded on the three national exchanges identified in the statutory definition.

All of the claims in the SCAC revolve around how Defendants wrongfully induced Plaintiffs to buy these non-covered company shares and partnership interests, and how Defendants failed to fulfill their professional and fiduciary duties to manage and monitor the Funds that issued those securities and to deliver accurate information regarding their investment performance. Indeed, these non-covered securities were the only securities ever bought, held or sold by Plaintiffs in their dealings with Defendants, who regularly sent plaintiffs account statements listing only such non-covered securities. *See, e.g.*, SCAC ¶ 335.

Instead of recognizing this inconvenient truth, Defendants focus on the purported "covered securities" that Madoff was supposed to have purchased through BMIS but never did, and argue that the fact "Plaintiffs were not supposed to have purchased the 'covered' securities directly is inconsequential." FG Br. at 22.

But Defendants' argument ignores critical and dispositive facts: Plaintiffs never invested with Bernard Madoff or BMIS. Rather, Plaintiffs invested in the non-covered securities issued by the FGG Funds. Plaintiffs purchased those non-covered securities in reliance on Defendants' representations and reputations that they would manage the Funds and perform due diligence, audits and custodial duties. Among other critical facts ignored by Defendants –

- The FGG Funds had hundreds of millions of dollars in legitimate investments that were completely unrelated to Madoff.[75]

[75] Sentry financial statements for the years ending Dec. 31, 2006 and Dec. 31, 2007, Declaration of Timothy A. Duffy (filed by PwC in support of the motion to dismiss), Ex. E at 18 ($170 million in non-Madoff funds); Ex. I at 17 ($219 million in non-Madoff funds).

- The money which Plaintiffs invested in non-covered Fairfield securities was deposited with Citco, the administrator of the Funds. SCAC ¶¶ 157, 328, 342.

- Citco calculated the NAV of the Funds on a monthly basis for purposes of purchases and redemptions, including in the calculation both legitimate non-Madoff investments and the fraudulent BMIS statements. SCAC ¶¶ 157-58, 327-35.

- Citco did not immediately send Plaintiffs' funds to BMIS. Rather, on a monthly basis, Citco looked at the amount of new purchases and redemptions for the Funds, and remitted to BMIS only the net amount of new purchases.[76]

- Only when some portion of Plaintiffs' money reached BMIS were the purported purchases of "covered securities" supposed to occur.

Courts have recognized that the required methodology for assessing whether the securities are covered under SLUSA mandates looking at the securities actually purchased and about which Plaintiffs complain. *See Pension Comm'ee of Univ. of Montreal Pension Plan v. Banc of America Securities, LLC*, WL 546964, at *2-3 (S.D.N.Y. Feb. 16, 2010); *Kenneth Rothschild Trust v. Morgan Stanley Dean Witter*, 199 F. Supp. 2d 993 (C.D. Cal. 2002). Using that analysis – indeed the only proper analysis – leads to the conclusion that the shares and interests in the Funds do not constitute covered securities.

At each step in this chain of events between Plaintiffs' purchase of non-covered FGG Fund securities and Madoff's eventual theft of investor monies, Defendants had independent contractual and legal duties and it is Defendants' failure to fulfill those duties that is the basis of Plaintiffs' claims. Indeed, the only "securities" that ever existed were those in the FGG Funds sold to Plaintiffs. For Defendants to claim that these facts are "inconsequential" is pure fantasy.

Defendants' legal argument – both as to whether "covered securities" are at issue and as to the "in connection with" requirement – turns on an out-of context quotation from the Supreme

[76] Alternatively, if the Funds' shareholder redemption requests exceeded new investments, Citco redeemed from BMIS the net amount needed to pay the Funds' shareholders. *See* Finkel Decl. ¶ 37.

Court in *Merrill Lynch v. Dabit*, 547 U.S. 71, 85 (2006), *citing O'Hagan*, 521 U.S. at 651, 117 S. Ct. 2199, that "it is enough that the fraud alleged 'coincide' with a securities transaction – whether by the plaintiff or by someone else." *See* FG Br. at 22-23.[77] In *Dabit*, the Court clarified its holding in *SEC v. Zandford*, 535 U.S. 813 (2002), by stating that the requisite showing of deception could be in connection with the purchase or sale of a security, and not just deception of a particular purchaser or seller. *Dabit*, 547 U.S. at 85.[78] In *Dabit*, the Court did not need to look any further than the deception practiced by Merrill Lynch analysts in publishing misleading reports that proximately caused investors' losses, and used the "coincides with" terminology only in ruling that SLUSA applies to holders, as well as purchasers and sellers, of "covered securities." Just as in *Dabit*, this Court need – and should – look no further than Plaintiffs' direct dealings with Defendants, which caused Plaintiffs' losses through purchases of the non-covered FGG Funds.[79] It is the securities actually purchased and about which Plaintiffs complain that are controlling. *See, e.g., Pension Comm.*, 2010 WL 546964, at *2-3; *Kenneth Rothschild Trust v. Morgan Stanley Dean Witter*, 199 F. Supp. 2d 993 (C.D. Cal. 2002).

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[77] Courts have warned against taking *Dabit* beyond its logical extreme, which is just what defendants are attempting here. *See, e.g., Gavin v. AT&T Corp.*, 464 F.3d 634, 639-40 (7th Cir. 2006) ("the 'connection' requirement must be taken seriously." "[O]f course there is a literal sense in which anything that happens that would not have happened but for some prior event is connected to that event . . . in the same sense the fraud is connected to the Big Bang."); *Drulias v. Ade Corp.*, 2006 WL 1766502, at * 2(D. Mass. June 26, 2006) ("While the Supreme Court recently embraced a broad interpretation of SLUSA, it did not suggest that all claims of breach of fiduciary duty in connection with the purchase or sale of securities are sucked into the SLUSA sluice").

[78] In *Zandford* the Court did not consider SLUSA, but instead addressed the proper scope of the "in connection with" requirement under other federal securities laws. In limiting the theoretical reach of that phrase, the Court noted: "our analysis does not transform every breach of fiduciary duty into a federal securities violation. If . . . a broker embezzles cash from a client's account ... then the fraud would not include the requisite connection to a purchase or sale of securities." *Zandford*, 535 U.S. 813, 825 n.4. Madoff's conduct regarding the Fairfield Funds is certainly analogous.

[79] The *Dabit* court also stressed that SLUSA preemption is not unlimited: "In concluding that SLUSA pre-empts state-law holder class-action claims of the kind alleged in Dabit's complaint, we do not lose sight of the general 'presum[ption] that Congress does not cavalierly pre-empt state-law causes of action.' *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996)." *Dabit*, 547 U.S. at 87.

For the same reasons, Defendants' other authorities (FG Br. at 22-23) are unpersuasive. In all such cases where the relationship between the parties fell within the ambit of SLUSA preemption, whether securities were purchased or not, there was at least a direct relationship between the plaintiff and the alleged fraudster or its agent purporting to sell "covered securities." No such connection exists here between Plaintiffs and Madoff or BMIS. *See, e.g., Sofonia v. Principal Life Ins. Co.*, 465 F.3d 873, 879 n.4 (8th Cir. 2006) (demutualization predicated on allegedly false valuation for insurance company amounted to purchase or sale of a "covered security" whether former policyholders received shares or cash measured by share value); *Instituto de Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1350 (11th Cir. 2008) (SLUSA applied where plaintiff alleged that Merrill Lynch was responsible for fraudster PFA's conduct because it allowed PFA to portray itself as Merrill Lynch's agent while soliciting plaintiff to buy covered securities); *Schnorr v. Schubert*, 2005 WL 2019878 at *4 n.11 (W.D. Okla. Aug. 18, 2005) (SLUSA applied where Ponzi scheme operator made false representations regarding investments in covered securities directly to plaintiff who invested with the fraudster); *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (9th Cir. 2002) (SLUSA preemption applied to claim by employees who alleged employees misrepresented value of employee stock options in connection with contract to sell covered shares in company stock).

2. SLUSA's "In Connection With" Requirement Is Not Met

Defendants' argument concerning the standard for the "connection" nexus rests on a similarly flawed attempt to expand *Dabit's* "coincide with" standard beyond all bounds of reasonable statutory construction and common sense. Defendants attempt to turn SLUSA into a black hole that would effectively subsume any tort or contract claim involving a securities firm. They go so far as to claim that "SLUSA preemption also applies because Madoff made misrepresentations in connection with his purported purchase and sale of covered securities," and

that these "misrepresentations count for SLUSA purposes because the statute does not require the misrepresentations or omissions to have been made by the defendants." FG Br. at 23-24. But Defendants' argument is insupportable based on the actual pleadings in the SCAC. Plaintiffs have never alleged that they had any contact with Madoff or BMIS or that they relied on anyone other than the Defendants in purchasing and holding the Funds' securities. On the contrary, the SCAC focuses on Defendants' misrepresentations, not Madoff's.

Plaintiffs' interpretation of SLUSA in this regard is supported by Judge Scheindlin's recent decision in *The 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). In *Pension Comm.*, investors in two BVI hedge funds sued to recover losses stemming from the funds' liquidation. As in the instant case, the plaintiffs alleged, *inter alia,* that Citco had prepared and distributed false NAVs and other performance data for the funds. Like the defendants here, Citco argued that because those funds had in turn purchased covered securities, SLUSA preemption applied under *Dabit*. The Court held, however, that "[o]nly the alleged misstatements by the Citco Defendants are relevant for an analysis of SLUSA preemption," and since those alleged misstatements only concerned the valuation of the funds, they were not made in connection with the purchase or sale of covered securities.

Accordingly, "[b]ecause plaintiffs purchased shares in hedge funds, rather than covered securities, SLUSA does not preempt plaintiffs' state-law claims." *Pension Comm.*, 2010 WL 546964 at *2. In reaching this conclusion, the court refused "to look beyond SLUSA's plain meaning and hold that the Citco Defendants' alleged untrue statements concerning the *Funds* were made in connection with the purchase or sale of covered securities," and concluded that:

> The interpretation of SLUSA urged by the Citco Defendants stretches the statute beyond its plain meaning. There are no grounds on which to justify applying

> *Dabit* to statements made by the Citco Defendants concerning *uncovered hedge funds* – even when a portion of the assets in those funds include covered securities. This outcome is required because the alleged fraud relates to those hedge funds rather than the covered securities in the portfolios.

Id. (emphasis original). As the court noted: "It is for Congress, not this Court, to extend SLUSA's 'in connection with' requirement to apply to untrue statements concerning the purchase, sale, and holding of shares of unregistered hedge funds like the Funds at issue here." *Id. See also Brehm v. Capital Growth Fin., Inc.*, 2008 WL 553238 at *2 (D. Neb. Feb. 25, 2008) (no SLUSA preemption where plaintiffs alleged that they were induced to purchase private placements and debentures by omissions made by defendants "by means of a facility of a national securities exchange" where there was no additional showing that such national exchange had listing requirements commensurate with required SLUSA "covered security" standards).[80]

In contrast to the facts and reasoning of *Pension Comm.*, which are directly applicable here, Defendants cite to cases which find SLUSA preemption or that the "in connection with" requirement has been met, all in readily distinguishable circumstances (FG Br. at 23-24). *See, e.g., Potter v. Janus Inv. Fund*, 483 F. Supp. 2d 692 (S.D. Ill. 2007) (SLUSA preemption found where plaintiffs purchased covered securities in funds that were then financially disadvantaged by the manipulative activities of arbitrageurs); *Indiana Elec. Workers Pension Trust Fund, IBEW*

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[80] Without undertaking the thorough analysis of the SLUSA issue in *Montreal Pension,* and without even citing that decision, Judge Griesa in *Barron v. Igolnikov*, 2010 WL 882890, at *8-13 (S.D.N.Y. March 10, 2010), held that SLUSA did preempt all state law claims against the manager and associated individuals of several Madoff feeder funds. The *Barron* opinion ignores the factual distinctions discussed herein, and its reasoning boils down to stating that the Supreme Court has "command[ed] that SLUSA be construed expansively," *id.* at *12 (which, as shown above, is wrong), and then stating, as an *ipse dixit* with no case support, that while the plaintiff class purchased only shares of non-covered hedge funds (just as in *Montreal Pension)*, "which in turn invested in covered securities – rather than [purchasing] covered securities directly from Madoff, SLUSA preemption is justified because the securities transaction need not have been performed by plaintiff." *Id.* at *13. Plaintiffs respectfully submit that this interpretation is wrong on the facts and wrong on the law. It would stretch the words "in connection with" beyond all reasonable intent of the statutory language to apply it in the context of the Madoff fraud and Defendants' defalcations in this case. The better reasoned and better supported view is that expressed in *Montreal Pension*.

v. Millard, 2007 WL 2141697 (S.D.N.Y. July 25, 2007) (SLUSA preemption not found under Delaware carve-out exemption where defendants issued allegedly false and misleading proxy materials relating to issuance of "covered security" stock options); *Fisher v. Kanas*, 487 F. Supp. 2d 270 (E.D.N.Y. 2007), *aff'd*, 288 F. App'x 721 (2d Cir. 2008) (SLUSA preemption found where plaintiff alleged that the sales price of her covered security would have been higher but for defendants' misleading proxy statements); *SEC v. Pirate Investor LLC*, 580 F.3d 233 (4th Cir. 2009) (in an SEC civil enforcement action under Section 10(b) raising no SLUSA issues, the court found the "in connection with" requirement met where defendants allegedly induced plaintiffs to purchase a special report via email solicitation so that they could learn about a "hot" uranium investment in a covered security); *Dommert v. Raymond James Fin. Serv., Inc.*, 2007 WL 1018234, at *12 (E.D. Tex. Mar. 29, 2007) (SLUSA preemption found where plaintiff relied on defendants' misrepresentations and omissions in establishing an account to buy and sell covered securities).

Recent Connecticut decisions that applied SLUSA in the context of Madoff investments are also unpersuasive here. In both *Backus v. Conn. Comty. Bank, N.A.*, 2009 WL 5184360 (D. Conn. Dec. 23, 2009); and *Levinson v. PSCC Serv., Inc.*, 2009 WL 5184363 (D. Conn. Dec. 23, 2009), the plaintiffs were effectively direct investors in the Madoff fraud by means of collective investment accounts that were created by the defendants; there were no separate legal entities such as the FGG Funds that were supposedly independently managed and fraudulently represented their own due diligence. Indeed, in *Levinson*, it was alleged that the defendants actually conspired with Madoff. Accordingly, in those cases, the links between the plaintiffs' claims, the defendants and Madoff were much closer than the attenuated relationship that exists here. As was aptly observed in *Pension Comm.*, 2010 WL 546964, at *3, "[u]nlike *Backus* . . .,

the covered securities are not 'at the heart' of this case. The purchase and sale of the *Funds'* shares are at the heart of this case" (emphasis original).[81]

3. SLUSA Is Not Applicable in Any Event to Plaintiffs' Non-Fraud Claims

Even if the Court were to conclude that some of plaintiffs' common law claims are preempted by SLUSA – which they are not – the remaining, non-SLUSA claims cannot be dismissed. *See Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 47 (2d Cir. 2005), *[rev'd] on other grounds*, 547 U.S. 71 (2006) ("SLUSA's language and legislative history indicate no intent to preempt categories of state action that do not represent 'federal flight' litigation."); *see also LaSala v. Bank of Cyprus Pub. Co. Ltd.*, 510 F. Supp. 2d 246, 274-75 (S.D.N.Y. 2007) (*Dabit* remains law of Circuit); *In re Lord Abbett Mut. Funds Fee Litig.*, 553 F.3d 248, 255-56 (3rd Cir. 2009) ("To require the dismissal of all of the other claims in the same action . . . is not supported by the plain language or legislative history. We hold therefore that SLUSA does not mandate dismissal of an action in its entirety where the action includes only some pre-empted claims"); *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (9th Cir. 2002) ("The breach of contract claims-garden variety state law claims...are not preempted by federal securities laws").

In this case, while the common law fraud and negligent misrepresentation claims may meet the statutory requirement in that they allege a "misrepresentation or omission" (albeit not with respect to a "covered security"), the other common law counts plainly do not include such allegations. The test for whether SLUSA applies to such claims is simple:

whether a material misstatement or omission in connection with the purchase or

[81] In a third Connecticut case, *City of Chattanooga v. Hartford Life Ins. Co.*, 2009 WL 5184706 (D. Conn. Dec. 22, 2009), the plaintiff had a direct relationship with the defendants, which sold covered securities (mutual funds), and was directly defrauded by the defendants' failure to disclose that they shared in the mutual funds' revenues from sales of those securities to plaintiff.

> sale of a covered security is a necessary component of the claim. To make this determination the simple inquiry is whether plaintiff is pleading fraud in words and substance.

Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc., 341 F.Supp.2d 258, 268 (S.D.N.Y. 2004); *see also LaSala v. Lloyds TSB Bank, PLC,* 514 F.Supp.2d 447, 473 (S.D.N.Y. 2007) (breach of contract claims not involving explicit allegations of misrepresentation and material omission survive SLUSA preemption).

Defendants' argument on this issue attempts to conflate Plaintiffs' fraud and negligent misrepresentation claims with Plaintiffs' other common law claims. *See* FG Br. at 21-22 n. 25. But the reality of the complaint is far different. The non-fraud claims simply do not include any allegations of "a material misstatement or omission" as a "necessary component of the claim." *Xpedior, supra.* All such counts can stand on their own based on their allegations that defendants failed to exercise the duties imposed on them by law or business practice, without regard to whether defendants misrepresented any facts. *See, e.g.,* SCAC ¶¶ 397, 408, 416, 418, 423.[82]

4. Defendants' SLUSA Argument Is Inconsistent with Congressional Intent to Promote Federalism by Preserving State Jurisdiction Over Non-Covered Securities

Defendants' SLUSA argument ignores Congress's clear intent to enhance federalism by preserving state authority to regulate the sale of non-covered securities. This is illustrated by the

[82] A particularly apt warning applies here:

> [T]he facts underlying a complaint may often give rise to multiple allegations (e.g., fraud, misrepresentation, and breach of contract). Because the determination of whether SLUSA applies may only be made by reference to what a party has alleged, and not what it could have alleged, *courts should be wary of a defendant's attempts to recast the plaintiff's complaint as a securities lawsuit in order to have it preempted by SLUSA.*

MDCM Holdings, Inc. v. Credit Suisse First Boston Corp., 216 F.Supp. 2d 251, 257 n.12 (S.D.N.Y. 2002) (emphasis added).

enactment of the "National Securities Markets Improvement Act of 1996," 110 Stat. 3416 (Oct. 11, 1996), codified at 15 U.S.C. §77r ("NSMIA"), two years before SLUSA. In the NSMIA, Congress established a bright-line test in which certain "covered securities" were exclusively subject to federal government regulation. *See* 15 U.S.C. §77r(a) ("no law, rule, regulations, or order, or other administrative action of any State . . . requiring, or with respect to, registration, or other administrative action of any State . . . requiring, or with respect to, registration or qualification of securities . . . shall directly or indirectly apply to a security that – (A) is a covered security."). Securities that did not meet this bright-line test continued to be regulated under State statutory and common law.

In 1998, Congress passed SLUSA, extending preemption of state securities laws to private claims asserted in certain class actions. SLUSA expressly incorporated by reference the definition of a "covered security" that had been used in NSMIA. *See* 15 U.S.C. §77r(a). As a result, investors in "covered securities" could assert private claims exclusively through federal causes of action in covered class actions, but through NSMIA were afforded substantial protection in the form of federal securities regulation and the availability of non-fraud private rights of action under the Securities Act of 1933, including Section 5 (filing of Registration Statements), Section 11 (false and misleading Registration Statements) and 12(a)(2) (public offerings pursuant to a prospectus).

In *Dabit,* once the Court concluded that the alleged misconduct involved trading in "covered securities" (shares recommended by Merrill Lynch for purchase by its customers), it read the "in connection with" language broadly to achieve the objective of SLUSA to preclude the application of state law to covered class actions. *Dabit,* 547 U.S. at 78 ("The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally

traded securities cannot be overstated."). Thus, *Dabit* stands for the unsurprising proposition that once the subject matter was found to be a "covered security," the "in connection with" language should be read broadly to preempt state law claims. *See id.* at 87 (referencing the "congressional preference for 'national standards for securities class action lawsuits involving nationally traded securities.' SLUSA § 2(5), 112 Stat. 1227.").

Defendants attempt to use *Dabit* and its predecessor *Zandford* to transform what are indisputably non-covered securities under NSMIA, such as the Fund shares, into covered securities, based upon some future contingency that might involve a covered security but that is far removed from the purchase or sale of the original non-covered securities. This argument misreads the unambiguous intent of Congress in defining a "covered security." Where the subject matter is not a covered security, and federal registration and remedies under the Securities Act are unavailable, federal law is not affected by, and plaintiffs should not be precluded from asserting, state law remedies. Rather, under the co-ordinated system of state-federal regulation that Congress put in place with NSMIA and SLUSA (using the identical definition of "covered security"), it is an affront to federalism to preempt state law claims.

5. Under Defendants' Choice-of-Law Arguments, SLUSA Preemption Is Inapplicable

Defendants have argued that plaintiffs' common-law claims are governed by either BVI or Delaware law. If the Court were to adopt this view (which we submit is incorrect, *see* Section II. A., above, then SLUSA by its terms would not apply. Under the statute's so called "Delaware carve-out" provision, class actions are exempted from SLUSA if the claims are brought under the law of the state of the issuer's incorporation (here, the FGG Funds are incorporated in BVI and Delaware) and involve purchase or sale of securities by the issuer to or from holders of the issuer's equity securities (here, the plaintiff class). *See* 15 U.S.C. § 78bbf(3)(A)(i), (ii)(I). That

is precisely the nature of the common law claims in this case if Defendants' choice-of-law arguments are accepted. Accordingly, the "Delaware carve out" would apply to exempt all of Plaintiffs' common law claims from SLUSA.

B. The Martin Act Does Not Bar Plaintiffs' Claims

1. The Martin Act Does Not Preempt Common Law Claims That Do Not Allege Violation of the Act or Its Implementing Regulations

The Martin Act contains no provisions preempting common law causes of action, and Defendants concede that the common law fraud claims are not preempted. *See* FG Def. at 18. Defendants fail to identify any language that would preempt non-fraud courses of action, and have offered no rational policy reason why the Legislature would do so. *See* FG Def. Br. at 18-20; Fee Def. Br. at 13. Rather, Defendants rely on questionable case authority that parrots prior decisions with virtually no analysis of the statute or credible reasoning.

The controlling principle is clear: "When interpreting a state statute, it is a federal court's 'job to predict how the forum state's highest court would decide the issues before it." *Cromer Fin. Ltd. v. Berger*, WL 1112548, at *4 (S.D.N.Y. Sept. 19, 2001), *quoting Sprint PCS L.P. v. Connecticut Siting Council*, 222 F.3d 113, 115 (2d Cir. 2000). Defendants' arguments that the New York Court of Appeals would find that the Martin Act preempts common law claims must be rejected because (i) the Act contains no express or implied preemption provisions; (ii) no Court of Appeals decision justifies preemption here; (iii) rather, state case law supports private litigants asserting common law claims that may parallel Martin Act claims by the State Attorney General; and (iv) no public policy warrants preemption.

The Martin Act (N.Y. Gen. Bus. Law, §§ 352-59) was passed in 1921, among other things, to grant the Attorney General jurisdiction to investigate and prosecute "fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale" with respect

to securities transactions. The Act contains no language that expressly or implicitly preempts common law causes of action. Nor have defendants advanced any policy rationale why the Legislature, in augmenting the Attorney General's authority, would seek to preclude private common law actions.

The Court of Appeals has held that there is no private right of action for violations of the Martin Act. *See CPC Int'l Inc. v. McKesson*, 519 N.Y.S. 2d 804 (N.Y. 1987); *Vermeer Owners, Inc. v. Guterman*, 578 N.Y.S. 2d 128 (N.Y. 1991). The absence of a private right of action, however, logically says nothing about whether common law claims should be preempted. In fact, the Court in *CPC* allowed common-law fraud claims to proceed, and did not address plaintiff's breach of warranty claims; while in *Vermeer* it addressed common law causes of action (breach of fiduciary duty, unconscionability and fraud) on the merits with no suggestion that they were preempted – and thereby strongly implied that they are not.

Indeed, far from indicating that the Martin Act should preempt private claims, the Court of Appeals "unanimously recognize[d] that there are reasons which suggest that the legislature consider the merits of a statutorily expressed [private] cause of action. By reducing the expectancy of reaping illicit profits from fraudulent securities practices, a private cause of action would act as a further deterrent." *CPC*, 519 N.Y.S. 2d, at 119-120 (citations omitted). Plaintiffs' common law claims here, of course, similarly "act as a . . . deterrent" to promote the public policy of deterring securities fraud expressed in the Martin Act and acknowledged by the Court of Appeals.[83]

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[83] This State policy was recently recognized in another Madoff feeder fund case when the court awarded attorneys' fees to a private litigant that had brought common law claims several months before the Attorney General commenced a parallel proceeding under his Martin Act authority. *See New York University v. Ariel Fund Limited*, 2008 Slip Op., 603803 (Sup. Ct. Feb. 25, 2010). The court overruled the Attorney General's objection to awarding fees, finding that "[i]t was NYU who first came to this court and who took on the financial risk of acquiring the restraining order by posting a $10 million bond.

More recently, in *Caboara v. Babylon Cove Dev., LLC*, 862 N.Y.S.2d 535, 538 (App. Div. 2008), the Appellate Division exhaustively analyzed the issue and held that the Martin Act does not preempt common law claims of fraud or breach of contract which rest upon the same facts that also would support a Martin Act violation as long as the facts satisfy traditional pleading rules. The court noted that "[n]o case from the Court of Appeals holds that the Martin Act not only failed to provide, expressly or impliedly, for a private right of action, but also, abrogated or supplanted an otherwise viable private cause of action whenever the allegations [also] would support a Martin Act violation." *Id.* at 538. *Caboara* emphasized that in the absence of clear legislative language that private lawsuits were preempted, the Martin Act must be read as cumulative with, rather than antagonistic to, private litigation (*Id.* at 539):

> [W]e note that the above determinations are in accord with basic tenets of statutory construction. The Legislature is presumed to be aware of the law in existence at the time of an enactment and to have abrogated the common law only to the extent that the clear import of the language of the statute requires (citations omitted). . . . Here, nothing in the clear import of the language of the Martin Act requires a conclusion that the Legislature intended to abrogate any common-law remedy arising from conduct prohibited under the act. Nor are the remedies afforded the Attorney General made exclusive by the Martin Act.[84]

Preemption of claims for breach of fiduciary and negligent misrepresentation also has been specifically rejected by the Appellate Division. In *Scalp & Blade Inc. v. Advest Inc.*, 722 N.Y.S.2d 639, 640 (App. Div. 2001), the court cited *CPC* and *Vermeer* (which federal courts have incorrectly read to justify preemption), and explained that these cases do not foreclose common law claims. The court held that "[n]othing in the Martin Act, or in the Court of Appeals

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Further, prior to filing its own complaint, the AG subpoenaed the discovery taken by NYU in its action. The AG does not refute NYU's assertions that this discovery assisted him in developing his complaint and ultimately filing his own action to protect the investors."

[84] It is noteworthy that the federal court cases finding preemption on which defendants rely have failed to recognize these controlling state law principles of statutory construction that must be applied when interpreting a New York statute like the Martin Act.

cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act." *Id. See also Bd. of Managers of Woodpoint Plaza Condo. v. Woodpoint Plaza LLC*, 2009 WL 2432346, at *6 (N.Y. Sup. Ct. Aug. 10, 2009) ("where plaintiffs sufficiently pled causes of action that are not predicated solely on the failure to comply with the Martin Act, they are not precluded from bringing common law causes of action").

In this court, Martin Act preemption was rejected in the careful and extensive analysis undertaken by Judge Cote in *Cromer*, 2001 WL 112548, at *4-5 (S.D.N.Y. 2001). As Judge Cote recognized in *Cromer*, "there is nothing in either of the New York Court of Appeals cases or in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action." *See Cromer*, 2001 WL 112548 at *4.

Defendants' briefing ignores this history and analysis that rejects preemption. Rather, defendants cite unpersuasive federal cases that (i) rely on state decisions where the plaintiffs' common law claims were dependent on violations of the Martin Act, or (ii) were decided prior to more recent state cases finding against preemption. *See* FG Br. at 18, *citing, inter alia, Kassover v. UBS AG,* 619 F.Supp.2d 28, 36 (S.D.N.Y. 2008); *In re Bayou Hedge Fund Litig.*, 534 F.Supp.2d 405, 421 (S.D.N.Y. 2007).

Those federal courts (and some state cases) have misread *CPC* as holding that state common law claims are preempted, primarily on the basis of three early state court decisions – *Horn v. 440 East 57th Co.*, 547 N.Y.S.2d 1, 5 (App. Div. 1989); *Eagle Tenants Corp. v. Fishbein*, 582 N.Y.S.2d 218, 219 (App. Div. 1992); *Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs.*, 595 N.Y.S.2d 492, 494 (App. Div.1993). All three of these state cases

involved common law claims which alleged violation of Martin Act disclosure requirements for residential real estate transactions. As to such real estate offerings, the Attorney General has issued extensive regulations pursuant to his authority under the Act. Under *CPC*, the three state cases were properly dismissed because violation of the Attorney General's regulations cannot be the basis for a private right of action. *See* M. Woodruff, *Does the Martin Act Preempt Common Law Causes of Action?*, NYLJ, Sept. 4, 2008, at 4 (federal cases finding preemption "were decided on improper grounds," because "they rely on [] Appellate Division cases involving litigation between sponsors and purchasers [of real estate projects], which reliance is misplaced since these Appellate Division decisions 'stand on materially different grounds' – i.e., that 'the plaintiff was attempting to use the Martin Act to make up for an element that would otherwise be missing under traditional rules of pleading and proof.'").

It is particularly significant that the New York Court of Appeals has now recognized precisely this distinction. In *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 879 N.Y.S. 2d 17, 23 (N.Y. 2009), the Court referenced its earlier *CPC* decision and reaffirmed its holding in that case that private plaintiffs may pursue common law fraud claims that do not "not turn on alleged nondisclosure of information required by the Attorney General's Martin Act regulations." In the instant case, of course, Plaintiffs' common law causes of action are pleaded without reference to any Martin Act violations and thus cannot be preempted.[85]

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[85] In a recent decision involving Madoff feeder funds, *see Barron*, Judge Griesa erred in misapplying *CPC* and its progeny to preempt private common law claims that did not allege Martin Act violations. For the reasons discussed in the text, the proper reading of New York law is that the Attorney General's authority is exclusive (and therefore preemptive) only with respect to claims that allege violations of the Martin Act or regulations promulgated there under. For similar reasons, Judge Sand's oft-cited dismissal of *Cromer* and *Scalp & Blade* as "islands in a stream of contrary opinion," *Nanopierce*, 2003 WL 22052894, at *4, substitutes numerology for analytical rigor and, of course, was rendered before the Appellate Division's comprehensive analysis in *Caboara*.

The Second Circuit initially addressed the issue of preemption in *Suez Equity Investors, L.P. v. Toronto Dominion-Bank*, 250 F.3d 87 (2d Cir. 2001). In *Suez*, the Court declined to follow the *Horn* and *Rego Park* cases which involved condominium regulations. It concluded that these cases "did not explore the issue with a level of depth that would justify a ruling [on preemption] in the first instance," and was not persuaded "that the [New York] Court of Appeals would follow their lead." *Id.* at 104-05.

Two months later, an entirely different panel of the Second Circuit in *Castellano v. Young & Rubicam, Inc.*, 257 F.3d. 171, 190 (2d Cir. 2001), citing *Horn* and *Eagle*, held that a fiduciary duty claim was "barred by the Martin Act." However, as noted in *Cromer* at *4 n. 6, *Castellano* ignored the Circuit's own decision in *Suez*, apparently believing that New York law was consistent on the preemption issue, while overlooking the contrary decision in *Scalp & Blade*. At the same time, the *Castellano* court acknowledged the importance of "respect for state courts . . . that have taken up the issue" of "interpretation of their own laws." 257 F.3d at 190.

With *Caboara* now having "taken up the issue" in detail, and *Kerusa* affirming that there is no preemption of common law claims that do not "not turn on alleged nondisclosure of information required by the Attorney General's Martin Act regulations" (906 N.E.2d at 1056), there can be no doubt that Judge Cote was correct in predicting that "[g]iven the skepticism expressed in *Suez Equity* of the *Horn* decision . . . the Second Circuit will adopt the analysis in *Scalp & Blade* when next confronted with the issue and the split in authority among the Appellate Divisions." *Cromer*, 2001 WL 112548 at *4 n. 6.

As also highlighted in *Cromer*, "the *Horn* court – on which many of [the cases finding preemption] relied – failed to provide any reasoning for its decision to uphold the fraud claims while barring the negligence and breach of fiduciary duty claims." *Id.* at *4. This distinction

between preempted non-fraud claims and allowable fraud claims has been followed by the federal courts. *See, e.g., Kassover*, 619 F. Supp. 2d at 39, *citing Nanopierce; In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 421 (S.D.N.Y. 2007). As *Cromer*, 2001 WL 112548, recognized, however, "there does not appear to be any basis in the Martin Act's provisions for a distinction between claims of fraud and claims for negligent misrepresentation." *Cromer* at *4. Moreover, such a rule would illogically mandate preemption in those non-fraud cases where the Attorney General is least likely to commence proceedings, but allow private claims in situations involving actual fraud, where the Attorney General is most likely to prosecute.

2. Alternatively, the Martin Act Does Not Apply because Securities Were Not Sold "Within or From" New York

Even if this Court were to recognize Martin Act preemption, Plaintiffs' claims should not be dismissed because Defendants here did not issue, sell, or distribute securities to plaintiffs "within or from" New York, to the extent necessary to apply the statute to Defendants' conduct. *See* N.Y. Gen. Bus. Law §352-(c)(1)(c); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, 2003 WL 22052894 (S.D.N.Y. 2003). Rather, this is a case which challenges the sale and marketing of the Funds on behalf of the overwhelming majority of Plaintiffs who reside outside of the United States.[86]

Where, as here, "the conduct was not confined to New York and, [] some plaintiffs may have interacted with defendants exclusively outside of New York," Martin Act preemption does not apply. *See, e.g., Robeco-Sage Capital, L.P. v. Citigroup Alternative Invs. LLC*, 2009 WL 2626244, at *18 (S.D.N.Y. Sept. 2, 2003) ("[B]ecause the solicitation of subscriptions in the

[86] The fact that application of New York substantive law is appropriate here given that substantial wrongdoing at the core of the claims occurred in New York (*see* Section II. A., above) does not impact on the construction of the Martin Act language ("within or from"), which looks to where the offending sales at issue took place. As shown below, where activity occurs both within and outside New York, the Plaintiffs' foreign presence renders the Act inapplicable.

CSO Funds was not confined to New York but largely took place in Cayman Islands, their interests do not relate to the solicitation and purchase of securities "within or from New York."); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 410 (S.D.N.Y. 2005); *Pension Comm. III*, 592 F. Supp. 2d 608, 639-40 (S.D.N.Y. 2009) (claims for breach of fiduciary duty and negligence not barred because, "[a]lthough the Citco Defendants communicated regularly with Lauer in New York, they performed most of their work for the Funds in Curacao, Netherlands Antilles"). In *Pension Comm. III* at 640, as in this case, "the securities were mostly marketed and sold to foreign investors, and only a limited number of investors in the United States participated." *Id.*, *citing Lehman Bros. Commer. Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 159, 165 (S.D.N.Y. 2001) (Martin Act did not apply where negotiations occurred between traders in London and Hong Kong and investor in Beijing).

In the present action, the Funds were primarily marketed and sold to international investors and the vast majority of plaintiffs interacted with Defendants exclusively outside of New York.[87] At least half of the individual defendants worked internationally or marketed the Funds to investors outside the United States.[88]

The fact that, as defendants point out, Attorney General Cuomo brought claims against Madoff "feeder fund" manager J. Ezra Merkin (FG Br. at 20), is irrelevant to the preemption issue. In the first place, private litigation against Merkin preceded the Attorney General's action in state court (*see* note 83, *supra*), while a separate case is proceeding in federal court. *See In re J. Ezra Merkin and Gabriel Capital Corp. Litig.*, 08-cv-10922 (S.D.N.Y.). In any event, choices

[87] Only three of 116 named Plaintiffs are New York residents. SCAC ¶¶ 1-116.

[88] *See* SCAC ¶¶ 126, 127, 130, 131, 136, 137, 138, 139, 140, 141, 143, 144.

involving the exercise of prosecutorial discretion and allocation of limited government sources are hardly an appropriate basis for statutory construction.[89]

VII. PLAINTIFFS ARE ENTITLED TO PUNITIVE DAMAGES

Plaintiffs assert punitive damage claims against the Fairfield Fraud Claim Defendants. *See* SCAC, ¶¶ 395-401. "To sustain a claim for punitive damages in tort, [only] one of the following [four] must be shown: [1] intentional or deliberate wrongdoing, [2] aggravating or outrageous circumstances, [3] a fraudulent or evil motive, or [4] a conscious act that willfully and wantonly disregards the rights of another." *Don Buchwald & Assocs. v. Rich*, 723 N.Y.S. 2d 8 (App. Div. 2001) (surreptitious diversion of clients to a secretly formed competitor). *See also Amusement Indus. v. Stern*, 2010 WL 445900, at *15 (S.D.N.Y. Feb. 9, 2010) (sustaining claim for punitive damages on allegations that an "attorney used its client's name and reputation" to negotiate "a significant real estate transaction without the knowledge or consent of its client, resulting in multiple multi-million dollar claims against the client."); *Gray & Assoc., LLC v. Speltz & Weis LLC*, 880 N.Y.S.2d 223 (Sup. Ct. 2009) (sustaining claim by non-profit hospital against financial advisors for replacing hospital employees with higher-paid independent contractors and secretly negotiating for the sale of the hospital).[90]

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[89] For example, all of the defendants in the Attorney General's *Merkin* action resided or had offices in New York, while the complaint referenced the large financial interests of numerous New York non-profit institutions and resident investors. *See* Complaint, *People v. Merkin,* 450879/2009 (April 6, 2009) ¶¶ 7, 14, 16, 17. Defendants claim, in a footnote, that the "within or from" New York requirement is satisfied "because a substantial portion of the events giving rise to the claims occurred in New York." FG Br. at 19 n.22, *citing Sedona Corp. v. Ladenburg Thalman & Co.*, 2005 WL 1902780, at *22 (S.D.N.Y. Aug. 9, 2005). In *Sedona*, however, "an entity situated in New York, conducted many of the complained of transactions with Sedona via telephone and mailings (including the Engagement Letter) from New York." *Id.* at *22. "In addition, the underlying securities, though registered to Sedona, a Pennsylvania company, were allegedly manipulated and sold short in New York markets." *Id.* at *22. Such facts contrast sharply to the facts here, where the tortious sales and marketing occurred almost entirely outside of the United States.

[90] The cases cited by Defendants (FG Br. at 74-75) are factually distinguishable. In *Kopec v. Hempstead Gardens, Inc.*, 696 N.Y.S.2d 53, 55 (App. Div. 1999), "only ordinary negligence [was] involved." *Id.*

Plaintiffs need not prove "harm aimed at the public generally," where, as here, "the very high threshold of moral culpability is satisfied." *Giblin v. Murphy*, 73 N.Y.2d 769, 772 (N.Y. 1988) (affirming punitive damages "on the established finding of defendants' wrongful diversion and squandering of corporate assets, granting of excessive credit, payments of salaries to themselves, and other acts constituting willful, wanton and reckless misconduct.").

Here, Defendants' fraud was of far greater scope and magnitude than any of these precedents. Defendants sold thousands of investors billions of dollars of interests in the Funds, and they reaped profits of hundreds of millions of dollars in fees, while misrepresenting known facts concerning their total absence of due diligence and monitoring that, if performed as represented, would have obviated these losses. As discussed throughout this brief and alleged in the SCAC, Plaintiffs have alleged conduct that is gross, wanton or willful, warranting an award of punitive damages.

VIII. PLAINTIFFS SHOULD BE ALLOWED TO AMEND THEIR COMPLAINT IF NECESSARY

Should the Court find Plaintiffs' SCAC deficient in any way, Plaintiffs respectfully request leave to amend to cure any such deficiency. Under Fed. R. Civ. P. 15(a), leave to amend should be "freely given," and "should be denied only for such reasons as undue delay, bad faith, futility of the amendment, and perhaps most important, the resulting prejudice to the opposing party." *Aetna Cas. and Sur. Co. v. Aniero Concrete Co., Inc.*, 404 F.3d 566, 603-604 (2d Cir. 2005). Particularly in complex securities cases, the Second Circuit encourages district courts to

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See also Outside Connection, Inc. v. DiGennaro, 795 N.Y.S.2d 669, 670 (App. Div. 2005) (plaintiffs failed to raise a triable issue of fact regarding defendants' alleged conduct in summary judgment motion; *Munoz v. Puretz*, 753 N.Y.S.2d 463, 466 (App. Div. 2003) (punitive damages unavailable for ordinary negligence); *Sforza v. Health Ins. Plan of Greater N.Y., Inc.*, 619 N.Y.S.2d 734 (App. Div. 1994) (no punitive damages where there was "only 'a private wrong, involving causes of action for breach of contract and ordinary fraud.'"). Moreover, each case (with the exception of *Sforza)* was a grant of summary judgment, rather than dismissal before plaintiffs had an opportunity to develop the factual record.

allow at least one opportunity to amend following guidance from the court. *See ATSI*, 493 F.3d at 108; *Ato Ram II, Ltd. v. SMC Multimedia Corp.*, 2004 WL 744792, at *6 (S.D.N.Y. Apr. 7, 2004) ("where plaintiff has not already attempted to correct a particularity deficiency, and when discovery has not yet ensued, courts typically grant leave to amend"). Although Plaintiffs have filed a Second Consolidated Amended Complaint, the instant motion represents the first legal test of their claims. Beyond this, Plaintiffs' ongoing investigation into Defendants activities has already revealed additional facts that would further corroborate Plaintiffs' allegations. *See* Finkel Decl. Under all the circumstances, Plaintiffs request to amend – if necessary – is reasonable and fully in keeping with the law of this Circuit. *See Loftin v. Bande* (*In re Flag Telecom Holdings, Ltd. Sec. Litig.*), 574 F.3d 29, 32 (2d Cir. 2009) (plaintiffs permitted to file a third consolidated amended complaint in a securities class action); *Meyerson v. Wickes Cos.* (*In re Boesky Sec. Litig.*), 882 F. Supp. 1371 (S.D.N.Y. 1995) (granting leave to file amendment to fifth consolidated amended complaint in securities class action).

CONCLUSION

For the foregoing reasons, the motions to dismiss filed by all of the Fairfield Defendants should be denied.

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Respectfully submitted,

By: /s/ David A. Barrett

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