Pacific West Health Medical Center Inc. Employees Retirement Trust et al ...ld Greenwich Group et al Doc. 109

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

ANWAR, *et al.*,

Plaintiffs,

v.

FAIRFIELD GREENWICH LIMITED, *et al.*,

Defendants.

This Document Relates To: All Actions

Master File No. 09-cv-118 (VM)

PLAINTIFFS' CONSOLIDATED OPPOSITION TO
THE FAIRFIELD GREENWICH DEFENDANTS' MOTIONS TO DISMISS

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PRELIMINARY STATEMENT

By their motions to dismiss, the FGG Defendants[1] seek to avoid responsibility for inducing thousands of investors around the world to invest billions of dollars in four investment vehicles managed by the FGG Defendants (the "Funds").[2] The Defendants in turn handed virtually all of those billions to Bernard Madoff with no meaningful pre-investment inquiry or post-investment oversight or monitoring. The FGG Defendants thereby provided the largest source of capital to the largest financial fraud in history. Defendants took hundreds of millions of investors' dollars as compensation while providing no discernible services. Yet they now seek to keep this undeserved windfall and avoid all liability for their reckless and fraudulent conduct. The Plaintiffs, meanwhile, have lost billions of dollars.

The Defendants are not being sued for their purported ignorance in not knowing Madoff was himself the world's biggest fraudster. The Defendants are liable because for at least a decade before 2008 they recklessly made utterly false statements, and omitted material information, in uniform sales documents distributed to thousands of investors. The false statements include: (1) that FGG's multi-billion dollar Funds had a track record of consistent returns; (2) that FGG took great care in selecting and supervising the Funds' investment

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[1] This brief is a consolidated response to three motions to dismiss that were filed by all parties related to Fairfield Greenwich Group ("FGG"): (1) Fairfield Greenwich Limited, Fairfield Greenwich (Bermuda) Ltd., Fairfield Greenwich Advisors LLC, Walter M. Noel, Jr, Andres Piedrahita, Jeffrey Tucker, Mark McKeefry, Fairfield Risk Services Ltd., Amit Vijayvergiya, Daniel Lipton, and Fairfield Heathcliff Capital LLC, ("FGG Defendants") (citations to the FGG Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "FG Br."); (2) Yanko Della Schiava, Philip Toub, Lourdes Barreneche, Cornelis Boele, Vianney d' Hendecourt, Harold Greisman, Jacqueline Harary, David Horn, Julia Luongo, Santiago Reyes, Lourdes Barrenche, Robert Blum, Corina Noel Piedrahita, and Maria Teresa Pulido Mendoza ("Fee Claim Defendants") (citations to the Fee Claim Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "Fee Def. Br."); (3) Richard Landsberger, Charles Murphy, and Andrew Smith ("Other Fairfield Defendants) (citations to the Other Fairfield Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "Other Def. Br.").

[2] The Funds are Fairfield Sentry Limited, Fairfield Sigma Limited, Greenwich Sentry, L.P., and Greenwich Sentry Partners, L.P.

managers; and (3) that FGG was undertaking rigorous measures to safeguard investments in the Funds. Each of these representations by Defendants about their own conduct was false, and Defendants knew they were false, or at the least recklessly made. And finally, it was not Madoff who made these false representations to the Plaintiffs; it was the FGG Defendants. Thus, it is Defendants' false statements about their own knowledge and activities that caused Plaintiffs to lose billions of dollars and are the foundation of this lawsuit.

The FGG Defendants have the temerity to suggest that they were themselves the "victims of Madoff's fraud" because they "lost tens of millions of dollars" they had allegedly invested with Madoff. What Defendants conveniently ignore, however, is the hundreds of millions of dollars that they took from Plaintiffs (and have refused to return) in the guise of "management" and "performance" fees for producing purported "profits" in Funds that never existed. (SCAC ¶¶ 236-49.) Far from being "victims," the FGG Defendants are among the greatest profiteers from Madoff's fraud.

Equally unavailing is Defendants' protestation that many others, including auditors and regulators, failed to uncover the fraud. (FG Br. at 2.) The SEC, which failed to uncover Madoff's Ponzi scheme, was itself misled by FGG, which had "trumpeted" to the SEC "their extensive due diligence of Madoff." The auditors PricewaterhouseCoopers LLP and the Fund custodians/administrators (the Citco entities) – who are defendants here – are responsible as well for fraud and gross violations of express duties to Plaintiffs by confirming the existence of billions of dollars in assets year after year, when no such assets existed.

Plaintiffs, in their continuing investigation of their claims, have learned that certain of the FGG Defendants had actual knowledge of Madoff's gross misrepresentations with respect to the "Split-Strike Conversion" strategy which he claimed to use to generate investor profits. For

example, Plaintiffs have interviewed a former consultant to FGG who has verified that on multiple occasions dating back to the mid-1990s, he informed FGG principals that Madoff was reporting that he had made "excess profit" option trades unrelated to the "split-strike" strategy, which inflated the Funds' purported profits by millions of dollars.[3] Because the "excess profit" trades were too large and consistently profitable to be believable, this witness urged FGG principals to investigate the trades with Madoff, including the identity of the counter-parties. Yet rather than undertaking meaningful investigation or due diligence concerning this information, the Defendants continued their pattern of misrepresenting their own knowledge and due diligence, while recklessly ignoring red flags, when even minimal investigation would have revealed Madoff's fraud and avoided Plaintiffs' massive losses.

The FGG Defendants' motions to dismiss are based largely on legal authorities which developed in contexts removed from what is admittedly the largest financial fraud by far in history. When Defendants' conduct is viewed as a whole in the context of Madoff's scheme, it is clear that Defendants have failed to provide legal justification to escape liability for their blatant misconduct:

First, Plaintiffs have standing to bring these claims because they were the direct recipients of the misrepresentations and omissions by FGG Defendants that led them to invest and hold money in the Funds. These representations were not made to the Funds, but to the investors, and are classic direct claims for intentional and negligent misrepresentations under federal and state law. Moreover, plaintiffs' losses are not merely "reflective" of the losses of the

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[3] *See* Declaration of Robert Finkel ("Finkel Decl.") ¶¶ 18-19. Because Plaintiffs identified this confidential witness after filing the SCAC, we do not cite his testimony here to support the sufficiency of the SCAC, which we believe is entirely adequate as it stands. However, this and certain other recently obtained evidence further confirm the basis for liability alleged in the SCAC. In addition, the extraordinary scope and size of the Madoff fraud and related actions such as this one have made lengthy and ongoing investigations inevitable. *See* Point VIII below, requesting leave to amend if the SCAC were deemed insufficient.

Funds, which are subject to netting and even potential "clawback" claims by Madoff's bankruptcy trustee, based on billions of dollars received by the Funds from Madoff in the form of redemptions.

Second, the FGG defendants assured investors that the monies entrusted to them were being placed in real investments, based on a proven track record of profitability, and assured plaintiffs of FGG's diligence in protecting those investments. These statements about FGG's actions and about the Funds that FGG managed – not about Madoff's operations – were either knowingly false or made with extraordinary recklessness. If these misrepresentations and omissions do not state a case under the Securities Exchange Act of 1934, then that statute is virtually a dead-letter, and fund managers will have open season to say anything they want to raise money.

Third, separate from federal claims, defendants' actions constitute common law fraud, negligent misrepresentation, breach of fiduciary duty and gross negligence.[4]

Fourth, Plaintiffs' contract-based claims properly seek recovery for money that the FGG Defendants paid themselves on the false basis that the FGG Funds actually made large profits, when in fact the Madoff investments were illusory. Similarly, the contracts with fund managers and advisors were clearly for the benefit of the investors, giving rise to third-party beneficiary claims.

Fifth, Plaintiffs' claims are not preempted by either the Martin Act or the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). The most recent and better reasoned

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[4] In the event the Court were to find that foreign law applies to any of the common law claims asserted, Plaintiffs have submitted Affidavits from Robert Miles, Q.C. (expert on U.K., British Virgin Islands ("BVI") and Bermuda law), Lewis Hunte, Q.C. (expert on BVI law) and Mark A. C. Diel (expert on Bermuda law), refuting and rebutting many of the conclusions reached by the foreign law experts proffered by Defendants and demonstrating that Plaintiffs have standing to bring the claims asserted in the SCAC and colorable claims in the BVI and Bermuda under many of the same or analogous legal theories as available under New York law.

New York decisions recognize that the Martin Act only preempts private claims that allege violations of the Act itself or its implementing regulations. And SLUSA cannot plausibly be read as intended by Congress to preempt claims arising from investments in off-shore funds not regulated by the SEC.

Sixth, because the Fairfield Greenwich Group repeatedly held itself out as a partnership to investors, and internally managed itself as such, it is liable to plaintiffs on that basis.

Seventh, the exculpatory provisions in investment management agreements do not – and lawfully, could not – shield the FGG Defendants from liability for their grossly negligent and fraudulent actions.

Finally, the FGG Defendants assert they should not be held to answer for punitive damages. If Plaintiffs ultimately prove that FGG Defendants recklessly raised billions of dollars from investors around the world without any concern for the truth or falsity of their statements, and without doing anything remotely approaching the actions they said they would take to protect investors, it is hard to imagine a fraud case more deserving of punitive damages.

ARGUMENT

I. THE SCAC PROPERLY ALLEGES EXCHANGE ACT FRAUD CLAIMS

The applicable legal standard for evaluating securities fraud claims is clear. To state a claim under Section 10(b) and Rule 10b-5 of the Exchange Act, a plaintiff must allege with particularity facts sufficient to show that a defendant: (1) in connection with the purchase or sale of securities; (2) made a materially false statement or omitted a material fact; (3) with scienter; and (4) the plaintiff's reliance on defendant's action (5) caused injury to the plaintiff. *ECA v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009). The SCAC pleads every element with respect to each of these defendants with particularity. These claims should be sustained.

A. The SCAC Properly Alleges Prima Facie Fraud Claims

From 1990 up to and until the arrest of Bernard Madoff in December 2008, the Fairfield Fraud Claim Defendants[5] marketed and sold interests in the Funds with offering materials (PPMs) that contained materially false and misleading representations and material omissions. As alleged in the SCAC, those misrepresentations induced Plaintiffs to invest in the Funds and ultimately caused them to suffer substantial economic damages. SCAC ¶ 181.

The SCAC alleges with particularity that during the Class Period the FFC Defendants made materially false and misleading statements to potential investors concerning: (1) the Funds' investment strategy and performance record; (2) the due diligence undertaken in hiring investment managers (including Madoff); (3) the post-retention "monitoring" of Madoff; and (4) Madoff's multiple roles at the Funds and the inherent risks created by not having any independent "check" on his multiple and conflicting activities.

With respect to each of these categories, as the SCAC alleges, the FFC Defendants made affirmative representations that were material to investors' decisions to invest. Moreover, as the SCAC also alleges, the FFC Defendants knew at the time they made the representations that they were false. At a minimum, they made these claims with a reckless disregard for the truth. Accordingly, the SCAC has more than met the burden of stating a securities fraud claim.

1. <u>False Statements Concerning Investment Strategies and Results</u>

The SCAC specifically alleges that the FFC Defendants made false statements about the Funds' investment strategy and performance history.[6] The false statements are described in

[5] The Exchange Act claims are brought against eleven "Fairfield Fraud Claim Defendants" (hereinafter "FFC Defendants"), who are FGG, FGL, FGBL, FGA, FRS, and Messrs. Noel, Tucker, Piedrahita, Vijayvergiya, Lipton and McKeefry. SCAC ¶ 151.

[6] The FFC Defendants cannot refute the SCAC's well-pled allegations that demonstrate the falsity of their statements. Defendants, instead, strain to recharacterize the SCAC as alleging that Defendants only

specific terms. They include misrepresentations about the Funds' trading strategy (the so-called "Split-Strike Conversion"), the mechanics of the supposed strategy, and the Funds' "track record":

> The Placement Memoranda issued by the Fairfield Defendants consistently described the investment strategy of the Funds as seeking to obtain capital appreciation of its assets principally through a "Split-Strike conversion" strategy. SCAC ¶ 184.
>
> The Placement Memoranda stated that: "The establishment of a typical position entails (i) the purchase of a group or basket of equity securities that are intended to highly correlate to the S&P 100 Index, (ii) the sale of out-of-the-money S&P 100 Index call options in an equivalent contract value dollar amount to the basket of equity securities, and (iii) the purchase of an equivalent number of out-of-the-money S&P 100 Index put options." SCAC ¶ 184.
>
> The Fairfield Defendants uniformly touted – in Placement Memoranda and other uniform sales materials – the Funds' historical track record of profitability. They "set[] forth . . . the prior trading results" of the Funds, and provided a table representing a rate of return that was positive in virtually all prior months of the Fund's operation and showed substantial, consistent annualized rates of return for the Funds. For example, the FS PPM of October 1, 2004 contained four single-spaced pages of month-by-month "performance" for the 13-year plus time period from December 1990 through December 2003. SCAC ¶ 187.

Moreover, the SCAC includes specific allegations describing in what particular respects those statements were false:

> These representations of the Funds' historical returns were false. Based upon government investigations to date, Madoff did not make any securities transactions in the thirteen years prior to his arrest. There were thus no profitable months for the Funds, because their assets were not invested. SCAC ¶ 188.

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promised to invest the assets of the Funds with an investment manager who employed the split-strike conversion strategy, and to conduct due diligence into, monitor, and verify the investments made by them. From this false premise, Defendants argue that a securities fraud claim cannot be based upon prospective statements, that is, promises. FG Br. at 52-53 (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 105-06 (2d Cir. 2007)). *ATSI* is distinguishable because it involved a promise to do something in a securities transaction, not a misstatement of fact in an offering document. *Id.* at 105. The Second Circuit found that the plaintiff had failed to allege facts showing that "when the promise was made, the defendant secretly intended not to perform or knew that he could not perform." *Id.* (citation omitted). Likewise, *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993), is distinguishable because it involved the failure to perform promises made in connection with various employment contracts. Here, of course, the SCAC does not allege mere promises, but rather material misstatements made to potential investors about what the FFC Defendants purportedly were doing on behalf of investors.

> The Fairfield Defendants failed to disclose to Plaintiffs the material fact that the historical returns were based solely on information provided by Madoff, and that they had failed to verify independently any of the returns they represented the Funds had earned over the years. SCAC ¶ 189.

In addition, the SCAC contains more than four pages of highly detailed allegations of specific misrepresentations concerning the Funds' performance provided by the FFC Defendants to Fund investors. SCAC ¶¶ 190–192.[7]

These representations are demonstrably false. The specific allegations are drawn from written statements made and published by Defendants with the intent that they be distributed to and relied upon by investors and prospective investors. Yet at the time the FFC Defendants issued these statements, they knew that they had never independently verified the existence or results of Madoff's "Split-Strike" strategy. *See, e.g.*, SCAC ¶¶ 184-186.[8]

In short, the FFC Defendants knew they had no basis for the statements both because they had made no effort to independently verify the information, and, because they had information that directly contradicted their representations.[9] SCAC ¶¶ 182, 185-86, 207-23. These

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[7] During the Class Period the FFC Defendants published the Funds' performance record in other uniform sales literature and monthly and semi-annual reports, which were distributed to investors. The reports contained detailed performance "data" for the Funds, all of which was false. For example, Defendants' August 2008 Monthly Strategy Review stated in part: "Fairfield Sentry Limited . . . returned 0.71% net in August 2008 and has returned 4.05% year-to-date. The S&P 100 Index advanced 1.44% during the month and has declined 12.36% year-to-date." SCAC ¶ 191(e). The September Review assured investors that "Fairfield Sentry Limited . . . returned +0.50% net in September 2008 and has returned +4.75% net year-to-date. The S&P 100 Index declined 7.60% during the month and has declined 19.02% during the year." SCAC ¶ 191(f).

[8] Indeed, evidence developed by Plaintiffs' counsel after filing of the SCAC, *see* Finkel Decl. ¶¶ 17-18, provides confirmation of the SCAC's allegations that Defendants had no knowledge of Madoff's actual operations. FFC Defendants knew that millions of dollars of Madoff's reported "profits" were likely derived from fabricated options trading.

[9] As discussed below, the assertion of these "facts" by the FFC Defendants in the face of contrary knowledge satisfies the "scienter" element of a well-pleaded complaint.

allegations clearly make out a securities fraud claim.[10]

2. False Statements Concerning Due Diligence in Hiring Madoff as Investment Manager

The SCAC's allegations of misrepresentations by the FFC Defendants in the Madoff hiring process are also specific and clear:

> The Fairfield Defendants represented that transparency was a key criterion when selecting a fund manager. They stated that among the qualities they "look[ed] for in managers," were "strong risk management"; "solid investment process"; "operational procedures"; "legal compliance"; and "transparency." SCAC ¶ 201.

As the SCAC further alleges, the notion that Madoff exhibited the kind of "transparency" that the FFC Defendants assured investors they demanded was, as was well known to Defendants, simply not true. In point of fact, as alleged in the SCAC: "Madoff refused to answer even basic questions about BMIS and its operations, let alone to permit the kind of due diligence and transparency that the Fairfield Defendants represented was necessary, was being undertaken, and that they should have undertaken." SCAC ¶ 218.

The FS PPM of August 14, 2006, FGBL's Form ADV Part II (attached as Appendix A), *see* SCAC ¶ 184 (note 1),[11] is replete with misrepresentations about the "thoroughness"

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[10] Courts have found similar misstatements actionable. *See In re Ashanti Goldfields Securities Litigation*, 184 F. Supp. 2d 247, 252-55 (E.D.N.Y. 2002) (misrepresentations about a risk mitigating strategy found to "fail to disclose the true nature of the investments.") *Id.* at 253. Recently, the Fourth Circuit, in reversing the dismissal of a complaint, held that statements regarding the defendants' policies on market timing fraudulently induced investors to purchase shares in the subject funds. *In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 117 (4th Cir. 2009). *See also Adams v. Hyman Lippitt, P.C.*, No. 05-72171, 2005 WL 3556196, at *7 (E.D. Mich. Dec. 29, 2005) (statements about nature and performance of investment actionable under 10(b)).

[11] The PPMs and their attachments are properly considered in determining the sufficiency of the pleadings, a point which Defendants concede in their Motions to Dismiss. See Declaration of Michael Thorne, Esq. ("Thorne Decl."), submitted by FFC Defendants with the Motion to Dismiss the SCAC at paragraph 23: "All of the documents attached hereto [a reference to multiple FFC Defendant offering documents attached to Thorne's declaration], except the SEC Report referenced in paragraph 21 above, were submitted with or referred to by Plaintiffs in pleadings in this action." *See In re Bayou Hedge Fund Litigation*, 534 F. Supp 2d 405, 413 (S.D.N.Y. 2007), aff'd, *South Cherry St., LLC v. Hennesse Group LLC*, 573 F.3d 98 (2d Cir. 2009) ("In deciding a motion to dismiss, this court may consider the full text of

undertaken in the selection process:

> Working with one of its affiliates (Fairfield Greenwich Advisors LLC, SEC registrant 80162504), FGBL conducts a detailed manager selection and due diligence process, analyzing such important issues as liquidity management, market and credit risks, management quality (which includes on-site visit(s), background, and reference checks), and operational, compliance, and regulatory risks. At the conclusion of the manager selection process, allocation of assets from the Offshore Fund to a successful hedge fund manager (which may be managed by an affiliate of FGBL) candidate will be determined based on a qualitative and quantitative analysis of each manager's potential for long-term risk-adjusted performance, relationship with other manager's previously seeded, and expected contribution to the targeted risk return profile.

The SCAC alleges the great lengths the FFC Defendants went to in order to create the impression of an exhaustive vetting process of Madoff:

> [The Defendants] further claimed they verified a potential manager's "portfolio analysis," "financial statements," "back office procedures," and "regulatory/legal procedures" before selecting a manager. (*Id.*) They also represented that their due diligence process involved *"check[ing] for a 'reputable' auditor,"* and an "understand[ing] . . . of explanation of valuation methods used [and] trade execution process. (*Id.* at 14-15)" (emphasis added). SCAC ¶ 201.

The SCAC exposes the fallacy of these misrepresentations as well. As an obvious example, the *"check[ing] for a 'reputable' auditor"* clearly did not occur. As the SCAC points out, when the FFC Defendants sought "to find out information about F&H . . . [t]hey discovered that F&H was operating out of a strip mall in New City, New York, and that '[i]t appears that Friehling is the only employee.'" SCAC ¶ 225. In other words, the SCAC alleges a clear misstatement about the quality of Madoff's auditor made by the FFC Defendants even though they knew it was not true.

As the SCAC alleges, misrepresentations made to potential investors about the manager selection process were materially false and caused harm to the plaintiffs. If the FFC Defendants had done the diligence they claimed to have done, they would not have retained Madoff as the

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documents that are quoted in the complaint or documents that the plaintiff either possessed or knew about and relied upon in bringing the suit.")

Funds' investment manager. *Nathel v. Siegal*, 592 F. Supp. 2d 452, 465 (S.D.N.Y. 2008) (finding falsity because the defendants allegedly "did not investigate the tax deductions or the wells and knew virtually nothing of the investment. . ."). The allegations as to Defendants' misrepresentations regarding the hiring process of the Funds' investment managers (including Madoff) are well pleaded.

3. False Statements Concerning Ongoing "Monitoring" of Madoff

As with the Funds' strategy, performance history, and the investment manager hiring process, the SCAC contains specific allegations of materially misleading statements made by the FFC Defendants about their purported monitoring of Madoff's activities. First, the SCAC alleges that Defendants claimed to understand and actively oversee Madoff's trading strategy.[12]

> The FFC Defendants also represented in the PPMs that they imposed "guidelines" on Fund accounts held by Madoff for implementation of the split-strike conversion strategy as well as other "Investment Restrictions":
>
> > The Split-Strike Conversion strategy is implemented by Bernard L. Madoff Investment Securities LLC ("BLM") [BMIS], a broker-dealer registered with the Securities and Exchange Commission, through accounts maintained by the Fund at that firm. The accounts are subject to certain guidelines which, among other things, impose limitations on the minimum number of stocks in the basket, the minimum market capitalization of the equities in the basket, the minimum correlation of the basket against the S&P 100 Index, and the permissible range of option strike prices [footnote omitted]. SCAC ¶ 195.

As the SCAC alleges, the FFC Defendants' supposed understanding of Madoff's trading strategy

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[12] The Appendices to the PPMs, the Forms ADV filed with the SEC, contained similar materially false statements concerning the ongoing monitoring of independent investment managers such as Madoff. According to the August 2006 FS PPM, Thorne Decl. Ex. 1, Sch. F continuation sheet, Items 4.A.(5), 4.B(8), and II.A., an affiliate of the FFC Defendants was to "conduct both pre- and post investment quantitative analysis of hedge fund managers, monitor the market risk and provide quantitative analysis supporting the asset allocation decisions across the firm's multi-strategy funds." The PPM stressed the "transparency" that would be the hallmark of monitoring efforts: "An important component of the FGG product platform is *the position level transparency that we receive from all single managers . . .*" (emphasis added). Moreover, the PPM states, that monitoring is accomplished with "sophisticated quantitative measurement tools." As the FFC Defendants well knew, this was empty rhetoric, and such monitoring did not occur.

was completely contrived and was compounded by false claims about the verification that was to purportedly be undertaken with respect to individual trades:

> The Fairfield Defendants uniformly and consistently represented to existing and potential investors that they conducted thorough due diligence and strict oversight of Madoff's operations, that they independently verified his transactions, and even that they had full transparency and privileged access to Madoff. Through these statements, the Fairfield Defendants recognized the type of diligence and monitoring that they should have been conducting as to Madoff, yet they failed to perform it. SCAC ¶ 193.

In addition, as the SCAC alleges, the FFC Defendants made numerous misrepresentations about the daily checking they would conduct on Madoff:

> [The Fairfield Defendants] repeatedly represented that they conducted daily monitoring of Madoff's activities and compliance with Fund guidelines. For example, they indicated that they conducted "detailed daily compliance monitoring of portfolio activity against all risk limits" and "daily positions-based risk measurement, performance attribution and other quantitative analytics." (Fairfield Sentry Limited Standardized Responses, Dec 2008 [paragraphs] 54, 69.) They similarly represented that "portfolio holdings are reconciled daily" using "proprietary software." (Fairfield Sentry Limited Due Diligence Questionnaire, Oct. 2007, at 21.) They further represented that: "The Investment Manager monitors compliance of the SSC strategy against these risk limits and guidelines each day." (Fairfield Sentry Limited Standardized Responses, Dec. 2008, [paragraph] 77.) SCAC ¶ 196.
>
> The Fairfield Defendants represented in the PPMs that defendant FGBL (the Funds' investment manager/general partner) was "responsible for the management of the Fund's investment activities, the selection of the Fund's investments, monitoring its investments and maintaining the relationship between the Fund and its escrow agent, custodian, administrator, registrar and transfer agent." SCAC ¶ 194.

The SCAC further alleges that the FFC Defendants represented that "regular on-site visits [of Madoff's firm] are conducted by a number of senior members of FGG's legal, operations, and risk teams" (SCAC ¶ 197) and that they maintained "deep, ongoing joint venture relationships" with their fund managers and would review on an ongoing basis "audited financials and auditor's management letter comments"; "accounting controls: from trade execution; to trade capture; to trade reconciliation with the Street, administrator, and fund; to

fund's books and records"; "bank reconciliations for irregular or outstanding items"; and "broker reconciliations to ensure completeness and existence of all securities." SCAC ¶ 202.

These representations were false. The FFC Defendants failed to conduct any meaningful monitoring of Madoff, let alone (as they represented above) the thorough monitoring of him as an investment manager in order to assess the manager's and the fund's performance, ensure that the manager adhered to fund objectives and guidelines, monitor cash flow, limit the risk to investors, and track the Fund assets. However, they did none of these. Indeed, not only did they not perform these rudimentary checks, they apparently misled the SEC about them. *See* Finkel Decl. ¶ 10 ("the enforcement team was assured by Fairfield Greenwich that it conducted regular audits of Madoff's operations and that it had confirmed that Madoff had maintained custody of the funds entrusted to him.")[13] They knew full well that such checks did not go on. As the SCAC alleges, Defendant Tucker never toured Madoff's office where the "strategy" was supposedly executed and did not know of anyone who did. SCAC ¶ 214. Providing these false assurances to investors was at the least reckless, and at worst, an intentional effort to defraud. As the SCAC alleges, had Defendants done what they claimed, they would not have kept Madoff on as the Funds' investment manager. These allegations – the supposed "monitoring" of Madoff that allowed the fraud to flourish – are properly pleaded.

4. Material Omission in Disclosure of Madoff's Multiple Conflicting Roles and the Associated Risks

The SCAC specifically alleges that during the Class Period the FFC Defendants did not disclose the risk of Madoff holding multiple roles of investment manager, clearing firm,

[13] The referenced material in the Finkel Declaration is part of the record made public by the SEC in connection with publication of a report by its Inspector General into the Madoff fraud. The OIG Report was submitted by the FGG Defendants in support of their motions to dismiss. FG Br. at 5. If the OIG Report is considered by the Court, *see, e.g., In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 402, 408 (S.D.N.Y. 2005), it is appropriate to consider also Finkel Exhibits 3 and 4 which confirm allegations in SCAC ¶ 234 concerning FGG's assistance to Madoff in thwarting the SEC investigation.

executing broker and custodian. *See, e.g.*, SCAC ¶ 212: "The Fairfield Defendants acquiesced to the unusual arrangement by which BMIS served as both the sub-custodian or custodian of Fund assets and the executing broker, as well as the investment manager."

Over the Class Period the description of Madoff's activities was materially deficient. For example, the FS PPM for October 1, 2004 at 14-15 (Thorne Decl. Ex. 13), stated that BMIS was a sub-custodian for the Funds with approximately 95% of the Funds' assets under custody. The PPM did *not* disclose that Madoff was also the sole investment manager and executing broker for the SSC strategy. By August 2006 the PPMs contained a fuller description of Madoff, but still did not disclose his role as investment manager. The PPM notes that BMIS is a broker-dealer, and the language conveys a functionary role: BMIS was the "execution agent," "implementing" the SSC strategy through "accounts maintained by the Fund" at Madoff. FS PPM-8/14/06, at 9-10, 16 (Thorne Decl. Ex. 1). In the August 2006 GS COM, Thorne Decl. Ex. 3, the reference to Madoff under "Management Fee and Expenses" describes his role as executing broker and clearing firm but *not* his role as investment manager: "The General Partner does not receive any compensation, directly or indirectly, with respect to the *brokerage and clearance charges* incurred in connection with the Partnership's account at BLM" (italics added). *Id.* at 20.

Portions of the offering materials devoted specifically to discussion of investment *risk* also failed to disclose Madoff's multiple roles. "Risk Factors" subsections[14] that appear throughout the 2004 PPM – as well as a separate section for "Potential Conflicts of Interest" – omit to mention Madoff at all, let alone the conflict of interest and attendant risk created by him serving as custodian, executing broker, and investment manager. FS PPM for October 1, 2004 at

[14] Numerous sections throughout the document contain a separate subsection for "Risk Factors", including sections on "Dependence Upon Principals and Key Employees of the Manager," "Conflicts of Interest," "Possibility of Misappropriation of Assets, and "Sole Proprietor Non-SSC Investment Managers." Similar sections appear in the 2006 PPM.

16-17, 20-21 (Thorne Decl. Ex. 13).

The August 2006 FS PPM, with nearly identical risk subsections as its 2004 counterpart, contains fleeting mention of Madoff, FS PPM for August 14, 2006, at 17-19, 22-23. (Thorne Decl. Ex. 1), and once again does not clarify his role as Fund advisor. Indeed, a section on key personnel seems to expressly distinguish Madoff from the Fund manager: "the services of the Investment Manager's [FGBL] principals and key employees and [Madoff] are essential to the continued operation of the Fund." FS PPM for August 14, 2006, at 18. An earlier reference in the PPM (at 16) reiterates Madoff's role as "executing broker." There is no statement that Madoff is the investment manager and custodian and no disclosure of the risks created by his multiple roles.

The first arguably adequate disclosure of Madoff's role at the Funds did not appear until December 2008, just days before the Ponzi scheme publicly collapsed. The FFC Defendants issued a new Fairfield Sigma PPM on December 1, 2008, that for the first time expressly identified Madoff as the Fund "manager." Thorne Decl. Ex. 2, FS PPM 12/1/08 at 20 no. 4. A new subsection to the "Risk Factor" section of the PPM entitled "Non Diversification" disclosed that "[s]ubstantially all of the Fund's assets . . . will be invested in accounts *managed* by" BMIS (emphasis added). *Id.* Even at that late date, however, the December 2008 PPM still failed to provide adequate disclosure of the extraordinary risk of having so many functions concentrated in one individual.[15]

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[15] In addition to the inadequate disclosures about multiple functions, FFC Defendants exhibited over the years an unusual ambivalence about mentioning Madoff by name, which is a further indicia of scienter. Notably, Madoff's identity as investment manager was disclosed to potential investors in PPMs that were effective through the end of 2002, after which those references were expunged. Madoff did not appear in offering materials again until 2006. Finkel Decl. ¶ 13, and Ex. 4 at 12419-23. The lengths that the FFC Defendants went to disguise Madoff's affiliation with the Funds is further evidence of scienter. *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72 (2d Cir. 2001) (pre-class period data is relevant when evaluating scienter allegations).

On this issue as well, the disclosures by the FFC Defendants were clearly at odds with the facts they had before them. As described in more detail below, the FFC Defendants exchanged emails in the fall of 2008 indicating that even at that late date they had virtually no access to Madoff and did not know how he functioned. *See* I. B. 6, below. Nonetheless, they failed to disclose their gross ignorance about these critical aspects of Madoff's operations (which necessarily had to exist in all years), and failed to apprise Fund investors of the risks and vulnerabilities of the Madoff arrangement. The allegations on this topic are well pleaded and, as described immediately below, create a strong inference of scienter.

B. The SCAC Properly Alleges Scienter

1. <u>Applicable Standards</u>

The PSLRA requires that plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Under Section 10(b) and Rule 10b-5, the requisite state of mind is an intent "to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)), or recklessness. *ECA*, 553 F.3d at 198; *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 194 (2d Cir. 2008) ("*Teamsters Local*"); *Novak v. Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000). Recklessness is "'at the least, . . . an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *ECA*, 553 F.3d at 198.

To determine whether a strong inference of scienter exists, the court must "accept all factual allegations in the complaint as true" and consider all of the allegations taken together. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (*Tellabs* I), 551 U.S. 308, 324 (2007). An inference of scienter need not be irrefutable, but should be considered "strong" when it is at least as likely

as any other inference.[16] *Tellabs I*, 551 U.S. at 324. In other words, a "tie . . . goes to the plaintiff." *Akerman v. Arotech Corp.*, 608 F. Supp. 2d 372, 382 (S.D.N.Y. 2009); *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513, 543 n.199 (S.D.N.Y. 2008). The Court should only consider opposing inferences that are plausible and "rationally drawn from the facts alleged," not the facts as a defendant would like them to be. *Tellabs I*, 551 U.S. at 314; *ECA*, 553 F.3d at 198.[17]

To satisfy the scienter requirement, a plaintiff "may (1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (2) allege facts to show that defendants had both motive and opportunity to commit fraud."[18] *Rombach v. Chang*, 355 F.3d 164, 176 (2d Cir. 2004); *ECA*, 553 F.3d at 198; *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 168-69 (2d Cir. 2000).

The Second Circuit has identified four types of allegations that will suffice to allege scienter. In addition to allegations that the defendants "(1) benefited in a concrete and personal way from the purported fraud," or "(2) engaged in deliberately illegal behavior," they include allegations that the defendant "(3) knew facts or had access to information suggesting that their public statements were not accurate," or "(4) failed to check information they had a duty to

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[16] "The Supreme Court's reasoning in *Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement . . . .Vague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter." *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008).

[17] Under *Tellabs I*, the defendant has the burden to show that the Complaint's allegations give rise to an inference of innocent behavior that is stronger than the inference of recklessness. *Akerman*, 608 F. Supp. 2d at 382.

[18] Conscious misbehavior "encompasses deliberate illegal behavior." *Novak*, 216 F.3d at 308. Motive entails "concrete benefits" that could be realized by the defendant's false statements and wrongful nondisclosures. *In re WorldCom, Inc., Sec. Litig.*, 294 F. Supp. 2d 392, 399-400, 412 (S.D.N.Y. 2003). Allegations of defendants' motive may not be considered in isolation; rather, the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint. *Tellabs I*, 551 U.S. at 325. The FFC Defendants' motive was to collect astronomical fees, and they do not contest opportunity to commit fraud.

monitor." *ECA*, 553 F.3d at 199 (*quoting Novak*, 216 F.3d at 311; *Teamsters Local*, 531 F.3d at 194); *In re Novagold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 297 (S.D.N.Y. 2009); *In re Worldcom, Inc. Sec. Litig.*, 294 F. Supp. 2d at 392, 412 (S.D.N.Y. 2003).

2. **Defendants Had Information Contradicting Their Misstatements in the PPMs**

The SCAC, as indicated, details numerous instances where the FFC defendants had information that directly contradicted their statements in the PPM. Demonstrating that a defendant "had access to information suggesting that their public statements were not accurate" suffices to plead scienter. *E.g., Novak*, 216 F. 3d at 311. *See, e.g., Cornwell v. Credit Suisse Group*, 2010 WL 537593 (S.D.N.Y. Feb. 11, 2010); *In re Marsh & Mclennan Companies, Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 480-81 (S.D.N.Y. 2006). Courts in other circuits are in accord. *E.g., Makor Issues & Rights, Ltd. v. Tellabs Inc. (Tellabs II)*, 513 F.3d 702, 704 (7th Cir. 2008) ("When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk.").

As the SCAC alleges, the FFC Defendants had substantial information that contradicted the trading strategy and performance they reported to existing and prospective investors. The FFC Defendants knew that Madoff refused to give them any information whatever about his trading strategy and that credible sources questioned how it was possible to achieve such results. Yet defendants hid their ignorance from investors, instead falsely assuring investors that they were informed of and confident in Madoff's trading strategy. These materially misleading disclosures provide a strong inference of scienter.[19]

[19] Subsequent to filing the SCAC, Plaintiffs' counsel learned from a confidential witness who had been hired by FGG to analyze Madoff's reported trades that he informed FGG several times a year from the mid-1990's onward that Madoff had reported suspicious "excess profit" option trades unrelated to the purported split-strike strategy that produced many millions of dollars in reported profits. The witness finally became so concerned about these trades that he insisted Defendants investigate them, which they

The allegations of contradictory information are also glaring with respect to the hiring and monitoring of Madoff. For example, in connection with the selection of the investment manager, the FFC Defendants set forth in the PPM and related materials extensive criteria they claimed to "look for in managers" but which, in practice, they never acted on. To conduct the meticulous search that FGG's offering materials represented had been done, Defendants would have had to have access to information from the prospective manager. The FFC Defendants would have had to obtain information about the "Split-Strike Conversion" strategy, portfolio composition and analysis, and how the investment strategy was implemented. The inference is overwhelming that if FFC Defendants had actually done the work they said they performed, they would have discovered Madoff's scheme. Instead, Defendants claimed that they had undertaken a careful selection process when they knew that no such thing had occurred. The SCAC's allegations regarding this failure by the Fairfield Defendants create an inference of scienter.

Moreover, once the manager was selected, the FFC Defendants claimed they were reviewing Fund holdings and communicating with custodians and/or trustees to monitor cash flow and fund compliance. In short, they represented that they had and would continue to monitor the manager.[20] SCAC ¶¶ 194-204. However, contrary to the assurances of a robust monitoring of Madoff's activities, the Defendants knew full well that they had virtually no

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had apparently never done. *See* Finkel Decl. ¶¶ 14-20, and n. 3 *supra*. This evidence further confirms Defendants' utter lack of any effort to verify whether there was any legitimate explanation for Madoff's too-good-to-be-true results. Yet they continued for years to report those results to Plaintiffs and pay themselves handsomely based on those numbers.

[20] An appropriate review and monitoring, consistent with what the Fairfield Defendants represented, would have included at a minimum a review of the size and structure of the manager's organization; ownership of the manager's organization; registrations and regulation of the manager (including Form ADV, if applicable); descriptions and biographies of the portfolio managers, and compensation and incentive arrangements for key employees; the back office operations, including the paper flow (computerized or otherwise) and procedures implemented for mark to market pricing and fund accounting; and the professional relationships of the manager, *e.g.*, custodian/broker dealer, administrator, auditor/accounting firm, and legal counsel. SCAC ¶¶ 193-204.

access whatever. The FFC Defendants did not have access to Madoff's accounts, so they could not possibly confirm that Fund investment guidelines were being followed. In addition, as alleged in the SCAC, Madoff did not allow them to examine trading records that would permit verification that transactions were even made, much less the transaction price or account value. SCAC ¶¶ 210-12.

The mental state of the FFC Defendants is revealed by their frantic emails in the Fall of 2008 concerning what they euphemistically called their "gaps" in knowledge of Madoff's operations. Each of the six individual FFC Defendants was a party to these emails. SCAC ¶¶ 206-09.

A strong inference, if not the only reasonable one, from these allegations is that the FFC Defendants were privy to information that flatly contradicted many statements they made in the PPMs. *See, e.g., Nathel*, 592 F. Supp. 2d at 465 (scienter shown by alleged misrepresentations that the defendants' "access to . . . documents that contradicted their public statements [and that defendant] . . . . Josephson did not investigate the tax deductions or the wells and knew virtually nothing of the investment . . ."); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 404 (S.D.N.Y. 2005). With respect to Fund performance, the hiring and monitoring of Madoff, and the risks created by his roles, Defendants were in possession of information that contradicted their misstatements to potential investors. These allegations create a strong inference of scienter.[21]

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[21] Although the FFC Defendants denied liability, the plausibility of the SCAC in alleging that the FFC Defendants failed to perform the due diligence, which the PPMs stated they were performing, is supported by Defendants' settlement with the Securities Division of the Commonwealth of Massachusetts. Finkel Decl. ¶ 4, Ex. 1. The Administrative Complaint there was "based on a profound disparity between the due diligence Fairfield represented to its investors that it would conduct with respect to [BMIS] and the due diligence it actually conducted, as well as misrepresentations to investors in its Sentry funds about Fairfield's degree of knowledge and comfort with respect to Madoff's operations." As part of their Consent Order with the Commonwealth (appended as Finkel Decl., Ex. 1),

3. The FFC Defendants Ignored Numerous "Red Flags" and Failed to Check Information They Had a Duty to Monitor

Throughout the Class Period, the FFC Defendants continually provided assurances about the strategy and performance of the Funds, the rigorous process for the selection of investment managers (including Madoff), and the purported careful monitoring of the activities of Madoff and of the Funds generally. Even if the FFC Defendants claim that they were not aware of contradictory information regarding these disclosures (which is not true), they cannot refute the multiple "red flags" that clearly alerted them to problems at the Funds. At a minimum, these red flags created a duty to investigate further. Instead, FFC Defendants turned a "blind eye" to all indications of problems with the Funds.

The SCAC's allegations concerning the FFC Defendants' scienter include a lengthy cavalcade of red flags that contradicted the information which Defendants provided to investors. By alleging these red flags in detail, SCAC ¶¶ 203-04, 217-25, 234, the SCAC fulfills the scienter element of a statutory securities fraud charge. These indicia of fraud, well known to the FFC Defendants, include:

> (1) *Lack of transparency*. Madoff was extremely secretive and refused to answer questions posed by the FFC Defendants and refused to provide access to records and access to the physical premises of Madoff's offices. SCAC ¶¶ 217-19;
>
> (2) *Lack of segregation of important functions*. Madoff served as investment manager, executing broker, he self-cleared his trades, and acted as custodian. At minimum, this structure should have alerted Defendants to the need for heightened scrutiny, monitoring and verification of transactions because of Madoff's multiple roles and their concurrent risks. SCAC ¶ 221;
>
> (3) *Implausibly consistent investment returns*. The impossible consistency of Madoff's reported results using the split-strike conversion strategy and the resulting investment returns was another warning sign. Among other things: (a) Madoff generally reported that he bought near daily lows and sold near highs with uncanny consistency; (b) Madoff always claimed to be fully invested in treasury

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FGBL and FGA agreed to a penalty and to provide restitution to all Massachusetts residents who were investors in three of the Funds in the approximate amount of $8 million. SCAC ¶¶ 250-58.

bills at the end of each quarter; and (c) Madoff's reported results were inconsistent with the split-strike strategy, which might reduce volatility but could not produce gains in a declining stock market. Madoff's reported results were unattainable and not replicable by others. SCAC ¶¶ 223 (6.), ¶ 224;

(4) *Inadequate auditing*. Madoff's accounting firm, Friehling & Horowitz ("F&H"), was an unknown firm plainly unequipped to audit a company of BMIS's size. The firm had at most three employees, one a retired partner living in Florida. F&H had not been subject to peer review since 1993 because it had represented in writing to the AICPA that it did not perform any audits. By 2005 the Fairfield Defendants knew that F&H "was operating out of a strip mall in New City, New York, and that '[i]t appears that Friehling is the only employee.'" SCAC ¶¶ 222, 225;

(5) *Paper trading records*. Madoff reported his trades using paper confirmations, with copies of the paper tickets received by the FFC Defendants 3 to 5 days after the transaction date. This was a far cry from standard industry practice. Delayed paper trading records are susceptible to manipulation. SCAC ¶ 223;

(6) *No "outsiders."* Key positions were held by Madoff family members, thus limiting third-party involvement. SCAC ¶ 220;

(7) *Prices outside reported trade prices*. Madoff reported trades at prices that were outside the stocks' actual trading ranges or took place on weekends, both of which are impossible. SCAC ¶¶ 223 (6.), 224;

(8) *References to the* Bayou Fund *fraud*. The Fairfield Defendants knew of the *Bayou Fund* fraud, in which an investment manager had been found not liable for misrepresenting the due diligence it had conducted when recommending an investment in a particular hedge fund. The FFC Defendants stated to prospective investors that their due diligence would have uncovered the *Bayou Fund* fraud. Nevertheless, the FFC Defendants either failed to conduct sufficient due diligence and/or failed to act upon the red flags which in fact were raised before them (SCAC ¶¶ 203-04); and

(9) *SEC investigation.* In 2005, the FFC Defendants knowingly assisted Madoff in thwarting an SEC investigation into his operations. Knowing that, as Madoff s largest investor, FGG would be a key witness in the SEC's investigation, the Fairfield Defendants sought and followed Madoff's instructions on how to approach their upcoming testimony. In a telephone conversation that began with Madoff telling Vijayvergiya and McKeefry that "this conversation never happened," Madoff instructed the Fairfield Defendants in what to say and what not to say to the SEC. The FFC Defendants aided Madoff in deceiving the SEC and, ultimately, Plaintiffs. The FFC Defendants compounded this betrayal of trust by citing to the inconclusive result of the SEC investigation in public statements to Fund investors as proof that Madoff and BMIS could be trusted as faithful

> manager and custodian of the Funds' assets. SCAC ¶ 234. Moreover, through a Submission placed on the SEC's website subsequent to the filing of the SCAC, Plaintiffs learned that Tucker and Vijayvergiya misled the SEC about the extent of FGG's due diligence of Madoff. Finkel Decl. ¶¶ 7-13, and Ex. 3. That Submission, on behalf of an SEC branch chief, reported that "the enforcement team was assured by Fairfield Greenwich that it conducted regular audits of Madoff's operations and that it had confirmed that Madoff had maintained custody of the funds entrusted to him" and that "the sophisticated principals of Fairfield Greenwich trumpeted their extensive due diligence of BLM and their confidence in BLM." Finkel Decl. ¶ 10, and Ex. 3 at 7 and 11.

Each of these warning signs was known to the FFC Defendants. The FFC Defendants not only disregarded each of these red flags, taking no action to protect the Funds, but they knowingly concealed many of them from the Plaintiffs. *Id.*[22]

The FFC Defendants' reckless failure to investigate establishes scienter. *See, e.g., Bruhl v. PricewaterhouseCoopers, Int'l,* No. 03-23044-Civ, 2007 WL 983263, at *4 (S.D. Fla. Mar. 17, 2007) (red flags inconsistent with investment strategy pleads strong inference of severe recklessness); *In re Converse Tech., Inc. Sec. Litig.,* 543 F. Supp. 2d 134, 142-45 (EDNY 2008) (finding scienter where it was alleged that the red flags were so obvious that defendants "must have been aware" of the alleged fraud); *In re Refco, Inc. Sec. Litig.,* 503 F. Supp. 2d 611, 649 (S.D.N.Y. 2007); *Anderson v. Transglobe Energy Corp.,* 35 F. Supp 2d 1363, 1368-69 (M.D. Fla. 1999) (allegations that defendant was reckless in overstating the potential and status of a

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[22] In further confirmation of Defendants' willful blindness to red flags, Plaintiffs' counsel learned through a confidential witness (the "CW") after filing the SCAC, that FGG used an outside consultant to review Madoff's trading records. *See* note 3, above. That outside consultant (the CW) was initially hired by defendant Tucker and stated that he repeatedly informed Defendants beginning in the mid-1990s that Madoff was making what he called "excess profit" options trades which added millions of dollars per year to the Funds' profits. These trades occurred several times a year, and they "looked anomalous" because they were not consistent with the split-strike strategy. These trades were always profitable, were "material" and each generated "typically millions" in profit. CW reported these trades in written reports to FGG and discussed them with defendant Vijayvergiya. In July 2008, following a spate of such trades, CW specifically told Defendants they should verify the trades and the counter-parties. Finkel Decl. ¶ 19. The invariable "material" profitability over many years of trades inconsistent with the split-strike strategy which was known to Defendants, standing alone, is a red flag of such magnitude as to demand intensive inquiry, yet even in 2008 Defendants apparently had never undertaken it.

business venture were sufficient to allege scienter).

The FFC Defendants cite to cases that, as a whole, stand for the unremarkable proposition that allegations of a failure to investigate red flags fail when the allegations do not explain how the defendant knew or should have discovered the fraud. FG Br. at 33-34 (citing *Hart v. Internet Wire, Inc.*, 50 Fed. Appx. 464, 466 (2d Cir. 2002); *In re PXRE Group, Ltd. Sec. Litig.,* 600 F. Supp. 2d 510, 539 (S.D.N.Y. 2009); and *In re Bayou Hedge Fund (Bayou)*, 534 F. Supp. 2d 405, 417 (S.D.N.Y. 2007), *aff'd, S. Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009)). Even these cases, however, acknowledge that "[t]he failure to conduct due diligence is not the same thing as knowing of or closing one's eyes to a known 'danger,' or participating in the fraud". *Bayou* at 417. In short, these cases are distinguishable.

Each of the cited cases involved pleadings far less specific and detailed than at issue here. *Hart* is inapposite because the facts which the plaintiffs labeled "red flags" were found by the court to be merely immaterial "typing errors and inconsistencies of naming" – a far cry from the substantive red flags that the FFC Defendants were confronted with. *Id.* at 466. In *PXRE Group*, 600 F. Supp. 2d at 538, the court rejected scienter allegations that were overly general and which failed "to allege that Defendants had knowledge of *specific* contradictory information, or, in several instances, that the information was available *at the same time* that Defendants made the challenged statements." *Id.* at 536. (emphasis in original). Here, by contrast, Plaintiffs identify specific information (Madoff's inordinate secrecy, a woefully inadequate auditing firm, efforts to obstruct an SEC investigation, an incomprehensible trading strategy, anomalous trades producing millions in "excess profits", among other things) that the FFC Defendants knew about and did not act on.

Defendants' heavy reliance on *Bayou* is misplaced. In *Bayou,* the district court dismissed

a complaint brought against Hennessee Group ("HG"), a consultant on investments in hedge funds. The dismissal was based on both the statute of frauds ("[a]t bottom this was a contract case," *Bayou*, 573 F.3d at 115) and failure to plead scienter. The instant case is very different from *Bayou*. There, the plaintiff was an investment advisory client of HG, and Bayou was one of multiple investment recommendations. HG did not operate its own "fund" and there were no written offering documents concerning HG's due diligence and monitoring responsibilities. The only written material, mailed to the plaintiff at the suggestion of a third party, was a generic brochure (a "marketing tool"). *Bayou,* 534 F. Supp. 2d at 407-10, 414.

The district court found that the plaintiff did not allege reliance on HG's representations concerning the Bayou Fund's profitability, the independence of its accountant, or its stated investment strategy. *Id.* at 416. Rather, the complaint relied solely on HG's failure to conduct due diligence, but in a situation where there was an absence of red flags. *Id.* at 417 ("[t]he failure to conduct due diligence is not the same thing as knowing of or closing one's eyes to a known 'danger,' or participating in the fraud"). The Second Circuit affirmed, similarly finding that the complaint *"did not allege any fact . . . that either made the falsity of any of the Bayou funds' representations obvious or that should have alerted HG that the Bayou funds' representations were dubious."* 573 F.3d at 112-13 (emphasis added). *Bayou* was only one of 150 investment funds marketed by HG, and HG only earned an annual management fee of 1% (and no performance fee) equivalent to a few hundred thousand dollars a year (*see* 573 F.3d at 104, 113) – compared to the almost $1 billion "earned" by FGG on Madoff since 2002 alone (SCAC ¶¶ 236-49). The Second Circuit specifically differentiated between the situation in *Bayou*, where the defendant was a consultant, and the circumstances – such as here – where the defendants were principals of the funds at issue. *Id.* at 114 ("*Novak* [*v. Kasaks,* 216 F.3d 300 (2d

Cir. 2000)] dealt with shareholder claims against one group of company officials . . . . The relationship between [plaintiff] and [HG], a consultant, does not parallel . . . the relationships that existed in *Novak").*

Moreover, missing were any allegations of red flags that would have "alerted" HG. *But see LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071 (S.D.N.Y. 1996) (denying motion to dismiss claims against credit rating service that had provided "AAA" rating to bonds issued in connection with a Ponzi scheme).

By contrast, the FFC Defendants acted in concert to convince Plaintiffs to invest in a specific Fund (rather than advising about 150 funds), based on specific disclosures about Madoff, fund performance, and the split-strike strategy, set out in a lengthy PPM, representing that defendants had selected a qualified manager (Madoff) after a thorough investigation. They represented also that they monitored, and would continue to monitor him, in his role as investment manager. Here, unlike in *Bayou,* an inference of scienter is drawn from the allegations concerning specific representations of undertakings made in the PPMs. Moreover, Plaintiffs allege that the FFC Defendants either knew of or "clos[ed their] eyes to [the] known "danger[s]," the numerous red flags outlined above. *See Bayou*, 534 F. Supp. 2d at 417.[23] Nor did the FFC Defendants conduct the investigation and monitoring that they represented or respond to the numerous red flags. Such cavalier indifference is strong indicia of fraudulent intent.[24]

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[23] As noted above at Section I. A. 1., in a remarkable display of gall, the FFC Defendants told prospective investors that their oversight, monitoring, and risk management processes were so superior that they would have avoided the Bayou Fund fraud. *See* SCAC ¶ 203-04.

[24] A recent decision in this district, *SEC v. Cohmad Secs. Corp.,* 2010 WL 363844 (S.D.N.Y. 2010), is still further removed from the facts of this action than is *Bayou*. As in *Bayou*, Cohmad was not a "feeder fund." Investors did not invest in Cohmad. Cohmad made referrals of clients to Madoff, analogous to any recommendation by a retail broker, and the clients themselves invested directly with Madoff.

4. **Plaintiffs Did Not Know of Key Red Flags Because Defendants Failed to Disclose Them**

Defendants assert that certain "red flags" were known to the Plaintiffs, through cautionary language in the Fairfield Defendants' offering materials and otherwise, and thus cannot be used to demonstrate scienter. To bar a claim, however, a defendant must show that the purported cautionary language is meaningful and directly relevant to the risk. *Commodity Futures Trading Comm'n v. Commodity Inv. Group, Inc.*, 2007 WL 1519002, at *6 (S.D.N.Y. 2007) (boilerplate risk language insufficient); *Sawant v. Ramsey*, 570 F. Supp. 2d 336, 343 (D. Conn. 2008). Moreover, this affirmative defense is not open to the party with a clear information advantage. *In re Prudential Sec. Inc. P'ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996) ("doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away."); *In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158, 183 (S.D.N.Y. 2003); *Steinberg v. PRT Group, Inc.*, 88 F. Supp. 2d 294, 301 (S.D.N.Y. 2000).[25]

Defendants' argument that the PPMs "explicitly and unequivocally disclose Madoff's multiple roles and concurrent risks," FG Br. at 35, 47, is simply not borne out by the allegations. Rather, as the SCAC alleges, Madoff's role as investment manager was for most of the relevant period not disclosed. *See Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 618

Cohmad had no contract with the investors and Cohmad had no responsibilities whatsoever, written or oral, to conduct due diligence, monitor or oversee the investments in the Madoff funds. The opinion makes not one reference to any such relationship or responsibilities. Since Cohmad was not a feeder fund, it had no prospectuses or sales materials concerning Madoff. 2010 WL 363844, at *2-3.

[25] *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 360 (2d Cir.), *aff'd*, 40 F. App'x 624 (2d Cir. 2002) (FG Br. at 47), is distinguishable because the company specifically warned that its securities might never be registered with the SEC, which was the same risk complained of by the plaintiffs.

(S.D.N.Y. 2008) (statement that "[t]he Fund may be unable to find a sufficient number of attractive opportunities to meet its investment objectives or fully invest its committed capital . . . neither warns Plaintiff that the Fund is currently undercapitalized nor discloses what effect such undercapitalization would have on the Fund's investment prospects"). The failure to disclose Madoff's multiple roles, the inherent conflicts and risks, and the total absence of internal controls is a glaring omission. Relatedly, although Plaintiffs may have been aware (from Defendants' marketing materials) of the purported consistent, profitable returns in the Funds or from published materials, that fact is beside the point. The same marketing materials falsely stated the Defendants were carefully monitoring Madoff using access to his operations which Plaintiffs did not have, and if Defendants had actually done what they claimed, it would have exposed any illicit activity. In light of those representations by Defendants, it was reasonable for Plaintiffs to rely on the reported returns, while the absence of any such monitoring renders any knowledge by Plaintiffs of the returns irrelevant, given Defendants' informational advantage with respect to these critical disclosures.

5. Defendants' Violations Involved Core Operations

A defendant's high-level position supports a strong inference of scienter when the alleged misrepresentations relate to the company's core operations. *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 491 (S.D.N.Y. 2004) (high-ranking officers "not entitled to make statements concerning the company's financial statements and ignore reasonably available data that would have indicated that those statements were materially false or misleading."); *In re Veeco Instruments, Inc. Sec. Litig.*, 235 F.R.D. 220, 232-33 (S.D.N.Y. 2006).[26] Allegations that

[26] Plaintiffs do not contend that the scienter requirement is met solely because the FFC Individual Defendants were senior executives of the FFC Corporate Defendants. See additional scienter allegations with respect to the FFC Individual Defendants, below. *E.g.*, *In re LaBranche Sec. Litig.*, 405 F. Supp. 2d 333 (S.D.N.Y. 2005).

a defendant "was integrally involved in running [the company] and evaluating the financial condition of the company" alone support a strong inference of scienter. *See, e.g., Zuckerman v. Smart Choice Auto. Group, Inc.*, 2000 WL 33996254, at *2 (M.D. Fla. Aug. 29, 2000). [27]

As the senior most officials at the Corporate Defendants, the individual defendants were involved in the day-to-day management of the FFC Entity Defendants, as well as the selection and supervision of Madoff. SCAC ¶¶ 124-29, 206-09. They knew firsthand the astronomical fees received as a result of the long-term relationship with Madoff (SCAC ¶¶ 124-29, 206-09, 236-49), and they were privy to, or were reckless in not knowing, Madoff's unsupportable trading strategy, the risks created by his multiple roles at the Funds, and the fictitious performance results. Scienter is properly pleaded in these allegations.[28]

6. Scienter is Properly Alleged Against Individual Defendants

While the allegations discussed above are more than sufficient to establish scienter, additional allegations with respect to Individual Defendants provide further evidence of their scienter. SCAC alleges that in an email exchange in September 2005 Defendants Tucker, Lipton and McKeefry discovered that Madoff's auditing firm, "was operating out of a strip mall in New City, New York, and that it appeared to have only one employee." SCAC ¶ 225. As alleged, none of the FFC Defendants followed up on this red flag.

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[27] However, courts have routinely sustained scienter allegations in cases involving senior company officials where, as here, the individual defendants had access to information relating to a core aspect of the business or its relevant subsidiaries – in this instance, the business of the due diligence and supervision of investment managers. *E.g.*, *Cosmas v. Hassett*, 886 F.2d 8, 12-13 (2d Cir. 1989); *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002); *Chalverus v. Pegasys., Inc.*, 59 F. Supp. 2d 226, 235 (D. Mass. 1999); *Epstein v. Itron*, Inc., 993 F. Supp. 1314, 1326 (E.D. Wash. 1998).

[28] The Defendants' claim that a lack of scienter as to individuals is "fatal to . . . scienter claims" against the corporate defendants is incorrect. In *Teamsters Local*, the Court held it "is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud." *Teamsters Local*, 531 F.3d at 195-96.

Further allegations pointing to scienter include a series of emails in the Fall of 2008 concerning what was euphemistically referred to as "gaps" in Individual Defendants' knowledge of Madoff's operations, specifically the red flags that they had continually ignored. All six of the Individual Defendants were privy to these emails. SCAC ¶¶ 206-09. The emails demonstrate that the SCAC has adequately alleged scienter against FFC Individual and Company Defendants.

Additional evidence of scienter is contained in allegations that the FFC Defendants helped Madoff thwart an SEC investigation. As Madoff s largest investor, FGG was certain to be a key witness in the SEC's investigation. In a telephone conversation that began with Madoff telling Vijayvergiya and McKeefry that *"this conversation never happened,"* Madoff told them what to say and not to say to the SEC. SCAC ¶ 234. In addition, information recently disclosed by the SEC collaborates that the FFC Defendants misled the SEC when questioned about their due diligence of Madoff. *See* note 13, above.

The SCAC sufficiently pleads that the Individual Defendants held positions with respect to the Funds that make them responsible for the misrepresentations contained in Fund documents. Noel, Tucker, and Piedrahita are "the main principals of FGL" and "principal officers" of FGG. *E.g.*, Thorne Decl. Ex. 1, FS PPM, 8/14/06, at 2, 8. Defendant Vijayvergiya also was a partner in FGG and served as the firm's Chief Risk Officer and President of FGBL. Each of these Individual Defendants is responsible for the written statements in the PPMs, their attachments and referenced documents.[29]

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[29] The SCAC alleges that Defendant Noel is a Founding Partner of FGG, has been director of various of its funds (including Fairfield Sentry and Fairfield Sigma), oversees all of FGG's activities, and is a director of FGL and of each of the Funds managed by Madoff. SCAC ¶ 124. *E.g.,* Thorne Decl. Ex. 1, FS PPM, 8/14/06, at 2, 8. As to Defendant Tucker, the SCAC alleges that he was a principal of several FGG entities, and he introduced the Madoff relationship to FGG, which later became the basis for Fairfield Sentry, SCAC ¶ 125; Thorne Decl. Ex. 1 at 2, FS PPM, 8/14/06, at 2, 8. Defendant Piedrahita is Defendant Noel's son-in-law, a founding partner of FGG, a director and President of FGBL, and the general partner of Greenwich Sentry and Greenwich Sentry Partners. Piedrahita has overall management

Scienter allegations in a private securities action were recently upheld by this court, *Cornwell v. Credit Suisse Group*, 2010 WL 537593, at *7 (S.D.N.Y. Feb. 11, 2010), where the complaint "allege[d] sufficient facts showing that the Defendants had direct knowledge of information contradicting their public statements or access to similar information they should have monitored." A critical consideration was that the complaint – as it does here – sufficiently alleged that information and red flags were available to the FFC Defendants to put them on notice that information they disclosed was false. The allegations here are well pleaded in that respect and should be sustained.

7. **Defendants Offer No Plausible Innocent Inferences**

Plaintiffs' scienter allegations establish the requisite strong inference that is "at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs I*, 551 U.S. at 324. The FFC Defendants have failed to proffer any plausible competing inference, let alone one sufficient to defeat the strong inference of scienter established in the SCAC.[30]

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responsibility for FGG. SCAC ¶ 126. Defendant Vijayvergiya was a partner in FGG and served as the firm's Chief Risk Officer and President of FGBL. Vijayvergiya focused on manager selection and risk management. Vijayvergiya had direct responsibility for monitoring and assessing the past and ongoing performance of the Funds' assets entrusted to Madoff. SCAC ¶ 127. Defendants Tucker and Vijayvergiya were specifically aware of Madoff's "excess profit" trades reported by the confidential witness. *See* Finkel Decl. ¶¶ 18-19. Defendant Lipton is FGG's Chief Financial Officer and a partner in the Operations Group. He received an M.B.A. in dual degrees in Accounting and Finance from New York University's Stern School of Business, is a Certified Public Accountant, and spent nine years at Ernst & Young as a Senior Manager, with responsibility for auditing and consulting engagements, specializing in alternative assets, private equity, venture capital, and domestic and offshore funds. SCAC ¶ 128. Defendant McKeefry is FGG's Chief Operating Officer/General Counsel and a partner in the Operations Group. He had significant discretion and control over assets in the Funds. He holds FINRA Series 7, 24, 63, and 65 licenses and is admitted to the bars of California and New York. SCAC ¶ 129. For the detailed facts concerning each of these six Individual Defendants, *see also* Thorne Declaration, Ex. 1, FS PPM, 8/14/06, at specific pages cited *supra* in this Brief and *passim*, and in Appendix A to the PPM, SEC Form ADV Part II.

[30] Defendants' own misconduct is not excused by Madoff's criminality. *See In re Bennett Funding Group*, 1997 Bankr. LEXIS 2366, 55-56 (Bankr. N.D.N.Y. Dec. 19, 1997) ("the liability of the defendant 'turns upon whether the intervening [criminal] act is a [] foreseeable consequence of the situation created by the defendant's negligence.'" *Id.* *See also* discussion in GlobeOp Br. at 12-14.

The FFC Defendants' suggestion that the failure of the SEC to detect Madoff's fraud vitiates their scienter is off the mark. The fact that the SEC may have failed to carry out its responsibilities is no evidence that these Defendants did not have the knowledge and opportunity to discover the fraud themselves. Indeed, recently disclosed SEC documents suggest that Defendants misled the SEC when they "assured" the "enforcement team" (which referred to them as "the sophisticated principals of Fairfield Greenwich") that they "conducted regular audits of Madoff's operations," "confirmed" Madoff's "custody of the funds entrusted to him," and "trumpeted their extensive due diligence of BLM and their confidence in BLM." Finkel Decl., Exh. 3 at 11, *see* note 13 above.[31] Although Madoff may have perpetuated a sophisticated fraud, these Defendants must be judged on the facts known or available to them, and on their own false statements and misconduct. In that regard, the SCAC alleges by far sufficient facts to state a claim.

8. <u>Defendants' Extraordinarily Large Fees Establish Motive</u>

The SCAC sets forth a motive distinct from normal profit in the ordinary course of business. Here, the FFC Defendants received on average more than $120 million each year in fees, and more than $747 million total from 2002 through June 2008, and considerably more than that from inception of the FGG-Madoff related funds, including performance fees that were

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[31] Moreover, the Exchange Act provides that "[n]o action or failure to act by the [SEC] . . . shall be construed to mean that the [SEC] has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein." 15 U.S.C. § 78z. *See also In re G.K. Scott & Co.*, n.21 (S.E.C. Release No. Jan. 14, 1994) ("A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation"); *Union Pac. R.R. Co. v. Chi. & N.W. Ry. Co.*, 226 F. Supp. 400, 406 (N.D. Ill. 1964) (not all inaction by SEC is dictated by the merits of the case; private actions are arguably most needed when authorities do not act). In addition, it appears that the SEC never sufficiently investigated Madoff to have been in a position to render an opinion on Madoff's operations. *See* SEC Office of Investigations, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Public Version)," Thorne Decl. Ex. 14, Aug. 31, 2009, Report No. OIG-509, at 286.

generated from gains derived from Madoff's purported returns. The performance fees, over $547 million alone from 2002 through June 2008, provided the bulk of the FFC Defendants' fees. SCAC ¶¶ 236-49. Because these fees were astronomical (even for the hedge fund industry) they far exceed the garden variety motive allegations that have been discounted by courts in this Circuit.[32]

In addition, the SCAC alleges that defendants received these exorbitant fees even though they were little more than glorified salesman. They received 20% of net profits, all of which were supposedly generated by Madoff's investment acumen, not defendants' investment skills. Getting paid at the same rate as the finest investment managers in the hedge fund world while having no such management skills or activities surely meets the requirement for allegations of unusually large fees. In *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 344-46 (S.D.N.Y. 2004), the Court found plaintiffs' motive allegations sufficient to allege scienter where an auditor was paid consulting fees of six times its auditing fees ($12 million versus $2 million). Similarly, in *Allied Irish Banks, P.L.C. v. Bank of Am., N.A.*, 2006 WL 278138, at *3-4, *9 (S.D.N.Y. 2006), the court found the motive allegations sufficient to allege scienter where the complaint alleged that defendants "earned unusually large brokerage fees," and charged an "exorbitant" rate of interest.

"Motive [] entail[s] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged." *Novak*, 216 F.3d at 307. The FFC Defendants willfully turned a blind eye to the myriad red flags alleged in the SCAC in order to generate *more than one-half billion* dollars in compensation from the Funds' investors.

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[32] *E.g., Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001) (rejecting generalized motives that could be "imputed to any . . . for profit endeavor").

Plaintiffs have raised a strong inference of scienter based on motive and opportunity.[33]

C. The Group Pleading Doctrine Applies

The group pleading doctrine survived the enactment of the PSLRA and courts in this circuit apply it regularly to cases involving securities fraud claims. *E.g.*, *In Re Marsh & Mclennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 479 (S.D.N.Y. 2006) ("Defendants' argument that group pleading is no longer permissible under the PSLRA is rejected."); *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 399 (S.D.N.Y. 2005); *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 438-41 (S.D.N.Y. 2005); *BHC Interim Funding, L.P. v. Finantra Capital Inc.*, 283 F. Supp. 2d 968, 980 (S.D.N.Y. 2003); *SEC v. Collins & Aikman Corp.*, 524 F. Supp. 2d 477, 489 (S.D.N.Y. 2007). The group pleading doctrine also is applicable to corporate affiliates. *E.g.*, *SEC v. Espuelas*, 579 F. Supp. 2d 461, 472-73 (S.D.N.Y. 2008) (applicable to corporate affiliate "with direct involvement in the daily affairs of the company").[34]

The FFC Defendants had direct daily involvement with the Funds. FGG is the parent entity. In addition, FGG has managed its own fund and "selectively identified external managers for affiliations where it serves as a managerial and distribution partner." FGL and FGBL are subsidiaries of FGG. The PPMs identify FGBL as the Funds' "investment manager." FGL was the Funds' previous investment manager, later the Funds' placement agent, and it oversees the

[33] The aggregate amount of fees creates an inference of scienter through motive, but it is also instructive to consider the "individual motives" as measured by their individual fees. As the SCAC alleges in ¶ 148, in 2007 and 2008 alone, the FFC Defendants reaped the following amounts (rounded down to the nearest million): Piedrahita ($73 million), Tucker ($49 million), Noel ($49 million), McKeefry ($8 million), Vijayvergiya ($5 million), and Lipton ($4 million).

[34] The FFC Defendants apparently do not contest that the group pleading doctrine is applicable here and that it links, for purposes of liability, each of the FFC Defendants (all entity defendants and all FFC Individual Defendants) to the alleged false statements. Defendants argue only that the group pleading doctrine is inapplicable to alleging scienter. FG Br. at 36-44. Individual scienter is addressed below.

marketing of the Funds' shares. SCAC ¶¶ 117-19; Thorne Decl. Ex. 1, FS PPM 8/14/06 at 2.

FGA, an affiliate of FGBL and a subsidiary of FGL, was jointly responsible with FGBL for "conduct[ing] the detailed manager selection and due diligence process" which selected Madoff as the independent investment manager. FRS, also an affiliate of FGBL and a subsidiary of FGL, shared office space with FGBL and along with FGBL "serve[d] as FGG's Risk Management team." *E.g.*, SCAC ¶¶ 120-21; Thorne Decl. Ex. 1, FS PPM, 8/14/06, at 2, ADV Sch. F continuation sheet at Items 4.A.(5), 4.B.(8) and 4.C.(7).

The individual defendants are similarly involved. Noel, Tucker, and Piedrahita are "the main principals of FGL" and "principal officers" of FGG. SCAC ¶¶ 124-26; Thorne Decl. Ex. 1, FS PPM, 8/14/06, at 2, 8. Each has served as a director or General Partner for a variety of defendants' Funds. *Id.* Tucker and Piedrahita, along with Vijayvergiya and Lipton, had control over Funds' assets, including those invested with Madoff. SCAC ¶¶ 125-28. Vijayvergiya, Lipton and McKeefry were partners in FGG, and they served as the Chief Risk Officer/President of FGBL, CFO of FGG, and COO/General Counsel of FGG, respectively. SCAC ¶¶ 127-29. Each of the individual defendants was compensated with placement, management, and performance fees derived from the Funds' investments with Madoff. SCAC ¶¶ 124-29. *See Rich v. Maidstone Fin., Inc.*, 2002 WL 31867724, at *8-9 (S.D.N.Y. 2002) (principal officer of broker-dealer could be primarily liable even where an employee had made the misrepresentations, because the officer had "substantial participation in" the scheme through his approval and direction of the acts constituting the fraud, and indeed "orchestrated" the scheme); *In re Vivendi Universal, S.A. Sec. Litig.*, 2004 WL 876050, at *9 (S.D.N.Y. 2004) (*Central Bank* does not "preclude the imposition of primary liability . . . [on] those who are alleged to have known of the fraud and participated in its perpetration" even where they did not make the

fraudulent statement).

Based on the foregoing allegations, each of the FFC Defendants is liable for the alleged misstatements made by or on behalf of the Funds.

D. The SCAC Sufficiently Alleges Reliance

In this Circuit, reliance, also called transaction causation, "requires only an allegation that 'but for the claimed misrepresentations or omissions the plaintiff would not have entered into the detrimental securities transaction.'" *Marsh*, 501 F. Supp. 2d at 489-90 (*quoting Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172) (2d Cir. 2005). Allegations of reliance are not subject to a heightened pleading standing, but need only be "plausible." *Tellabs I*, 551 U.S. at 324. Here, the SCAC alleges that Plaintiffs "relied, to their detriment, on such misleading statements and omissions in purchasing limited partnerships or shares in the Funds." SCAC ¶ 373. Here, specifically, all class members were required to verify that they had received the unique offering documents as a condition to buying interests in the Funds. SCAC ¶ 181. That is all that is required at the pleading stage under Rule 8(a). *See Marsh*, 501 F. Supp. 2d at 489-90; *see also Transit Rail, LLC v. Marsala*, 2007 WL 2089273, at *7 (W.D.N.Y. 2007); *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, 2001 WL 1111508, at *9 (S.D.N.Y. 2001) (reliance requirement "not designed to shield perpetrators of fraud by forcing investors to conduct exhaustive research every time they invest money") (citation omitted).

Contrary to the FFC Defendants' claim, the Plaintiffs were *not* privy to critical information that, the SCAC alleges, the FFC Defendants withheld – most of the offering memoranda made no mention or only a passing reference to Madoff, and no reference to the trading anomalies that Madoff reported to FGG. Equally important, the Defendants misrepresented their efforts in selecting and monitoring Madoff. Plaintiffs could (and did) reasonably believe that Defendants' efforts provided assurance that Madoff's reported

investment results were legitimate. These circumstances make this case far different from the cases relied on by Defendants. FG Br. at 44. For example, in *In re Citigroup Auction Rate Sec. Litig.*, 2009 WL 2914370, at *6-8 (S.D.N.Y. 2009), the plaintiffs had information (a 2006 SEC Order, trade confirmations, language from the broker's website) that made it clear to any potential purchaser that the ARS market might not trade like an open, public market. Similarly, in *Creditsights, Inc. v. Ciasullo*, 2008 WL 4185737, *14 (S.D.N.Y. 2008), decided under state law, the court found that "plaintiff has not pleaded any legal duty, nor can the Court ascertain one, outside a duty to perform under the contract, upon which he justifiably relied." In other words, and unlike the allegations here, plaintiffs did not plead any prior material misrepresentations which caused them to act.

For similar reasons, reliance by the FFC Defendants (FG Br. at 47) on *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1542 (2d Cir. 1997) and *Belin v. Wiessler*, 1998 WL 391114, at *5-8 (S.D.N.Y. 1998), is misplaced. In *Lazard*, the decision was partly based on written disclaimers that the purchaser could not rely on oral representations; and the remainder "involved situations in which the relevant facts were easily accessible to the relying party." In *Belin* (at *3) the decision rested on "documents either in plaintiff['s] possession or of which plaintiff[] had knowledge and relied on in bringing suit." Here, only the FFC Defendants knew whether they had performed and were performing the due diligence and monitoring which appeared to verify Madoff's returns, and only Defendants knew of the many material anomalies in Madoff's trading reports.

Defendants cite *Crigger v. Fahnestock & Co.*, 443 F.3d 230, 235 (2d Cir. 2006) and *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103, 145 (S.D.N.Y. 1989), FG Br. at 45, concerning a sophisticated investor's obligation to access information. However, as the

Defendants themselves assert: "sophisticated investors are deemed to be on notice of all publicly available information concerning their investments." FG Br. at 45. It was far from public knowledge, and certainly not readily available information, that the FFC Defendants were fabricating their disclosures about the selection and monitoring of Madoff and his multiple roles. Plaintiffs were not "on notice" that Madoff was falsifying his returns out of whole cloth, and the Defendants' assurances that they were checking and verifying assets were also false. Because Defendants failed to disclose material information in that regard, Plaintiffs relied on the FFC Defendants to their detriment.

E. The SCAC Sufficiently Alleges Loss Causation

The SCAC adequately alleges loss causation as the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff. *See Lentell*, 396 F.3d at 172. "[A] misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations." *Id.* at 173.

As alleged in the SCAC, the FFC Defendants' misstatements concealed for many years the risk that the Funds' reported performance results were not based on actual investment gains. The Funds' fabricated results, uninvestigated and unchallenged by the FFC Defendants, allowed the fraud to continue and to flourish. The failure by the FFC Defendants to follow up on suspicious information about Madoff and the Funds, all led directly to the Plaintiffs' losses. *See Lentell*, 396 F.3d at 173.

The SCAC alleges in detail the information, ignored by the FFC Defendants, that allowed the Madoff fraud to flourish: the operations and compliance structure that were inherently suspect and subject to material conflicts of interest; the unverifiable returns; the paper trading records and incorrect reports; the nonsensical trading "strategy"; the "monitoring" that never took place; and the misrepresentations about the level of care that went into auditioning and

selecting Madoff in the first place. The FFC Defendants knew of but failed to pursue these red flags. The SCAC adequately alleges that the misconduct by the FFC Defendants caused the Plaintiffs' losses.

F. The SCAC Sufficiently Alleges Control Person Liability

A control person claim under § 20(a) requires, on the face of the statute, allegations (1) of a primary violation of the securities laws; and (2) of control of the primary violator by the defendant. *SEC v. First Jersey Sec.*, 101 F.3d 1450, 1472 (2d Cir. 1996). The need to allege a third element – that the controlling person was a "culpable participant" in the fraud – is less clear. The requisite elements have been met. Plaintiffs have adequately pleaded allegations with respect to the FFC Defendants and three members of the Executive Committee (the "Controlling Defendants"). The primary violations are pleaded in detail by reference to the numerous misrepresentations in the PPMs and elsewhere. The control element is met by virtue of the Controlling Defendants' active participation in the activity of the Entity Defendants. To the extent it is required, the Controlling Defendants' intimate involvement and high-level positions adequately allege culpable participation. *See Credit Suisse*, 2010 WL 537593 at *8.

1. <u>The SCAC Sufficiently Alleges "Control"</u>

"To survive a motion to dismiss [a]t the pleading stage, the extent to which the control must be alleged will be governed by Rule 8's pleading standard." *In re Converium Holding AG Sec. Litig.*, 2006 WL 3804619 at *14 (S.D.N.Y. 2006), *quoting In re WorldCom,* 294 F. Supp. 2d at 415-16. Control over a primary violator may be established by alleging that the defendant "possessed 'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'" *First Jersey*, 101 F.3d at 1472-73.

In *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 485-92 (S.D.N.Y. 2005), this Court

concluded unsurprisingly that a minority shareholder and an outside board member were not controlling persons under Section 20(a). *Id.* at 493 and 499. On the other hand, *Alstom* affirmatively found that the complaints sufficiently alleged that two *management* defendants *were* control persons. *Id.* at 493-95.[35]

Here, the Controlling Defendants had responsibilities regarding the distribution of offering materials and the purported due diligence with respect to the selection and monitoring of Madoff. By virtue of their high level positions, participation in the Funds' operations, and knowledge of the Funds' products, sales, accounting, and other pertinent information, they had the power to influence and control the activities of the FFC Defendants. SCAC ¶ 376.[36] Indeed, their failure to exercise appropriate control over FFC Defendants allowed the fraud to continue unabated.

The SCAC contains specific allegations about the position and influence of the FFC Defendants (*see* Section I. A. 2, above) and the three Executive Committee members as well. That is all that is required at the pleading stage.[37]

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[35] *Alstom* indicates that allegations are sustainable in direct proportion to a company official's "hands on" involvement with the company: "The CEO or COO presumably has the power to control a corporation in a way that an outside director does not. *** [I]n the cases stating that officer or director status is insufficient, such proposition was used to require more allegations to plead control by an outside director or some figure other than an internal officer. *** It may be that *fewer additional facts need be alleged to support an inference of control by a CEO or similar internal officer* than control by an outside director." (*Id.* at 488, note 51).

[36] *See Converium*, 2006 WL 3804619, at *46: "Plaintiffs have clearly met their burden with respect to the Officer Defendants. Plaintiffs allege that, 'by reason of their status as officers and members of the Executive Committee of Converium during the class period,' the Officer Defendants 'controlled the conduct of [the] business, the establishment of its loss reserves, the novation of its contracts, the information contained in its filings with the SEC, and public statements about its business.'"

[37] Defendant Landsberger was a partner in FGG's Client Group, and a member of its Executive Committee. Landsberger joined FGG in 2001 and was responsible for business development, including the marketing of Madoff-related investments, in Europe and Asia. Landsberger had over 20 years of experience in capital markets at the time of the events at issue, and was Managing Director of Fixed Income Sales at PaineWebber and Citicorp Securities prior to joining FGG. SCAC ¶ 130. According to

Plaintiffs' allegations of control person liability are at least as compelling as in *Alstom* and *Hemming*, and those claims against the Controlling Defendants should be sustained. *See also Credit Suisse Group,* at *8 (sustaining control person claims against "four individuals [who] had 'high-level positions' giving them 'intimate knowledge of the false financial statements' at issue[.] [E]ach is alleged to 'have had the power to control or influence the particular transactions giving rise' to the fraud."); *Varghese v. China Shenghuo Pharmaceutical Holdings, Inc.*, 2009 WL 4668579, at *11-12 (S.D.N.Y. 2009) ("controlling persons . . . by virtue of their high-level positions and "participation in and/or awareness of the Company's operations".). Allegations concerning the Controlling Defendants' high officer positions and compensation within the company, long tenure and training in the financial industry, prominent references to them within the PPMs and COMs, and knowledge of the Madoff relationship all serve to establish the "control" element.[38]

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documents produced in the Massachusetts proceeding, Landsberger had a 4.43% partnership interest in FGG as of 2008, and drew individual partnership compensation in 2007 and 2008 of a combined $15.6 million. SCAC ¶ 148. Extrapolating that compensation back to his initial 2001 employment yields total FGG-related compensation of approximately $50 million over seven years. Defendant Murphy was a partner in FGG's New York office, and a member of FGG's Executive Committee. Murphy had responsibility for FGG's and capital markets business. He had significant discretion and control over assets in the Funds. SCAC ¶ 134. According to documents produced in the Massachusetts proceeding, Murphy had a 1.97% partnership interest in FGG as of 2008, and drew individual partnership compensation in 2007 and 2008 of a combined $9.05 million. SCAC ¶ 148. Defendant Andrew Smith ("Smith") was a partner in FGG's *Investments* Group and a member of its Executive Committee. Smith was FGG's Chief Risk Officer and President of FGB. Smith was based in FGG's New York office. According to documents produced in the Massachusetts proceeding, Smith had a 2.36% interest in FGG as of 2008, and drew individual partnership compensation in 2007 and 2008 of a combined $8.35 million. SCAC ¶ 148.

[38] The cases cited by defendants are distinguishable. In *Rubinstein v. Skyteller, Inc.*, 48 F. Supp. 2d 315, 319 (S.D.N.Y. 1999), the court found allegations against a company "treasurer" insufficient because the putative control defendant was alleged to be "de facto treasurer" based on her marriage to the actual treasurer. In *Hemming v. Alfin Fragrances, Inc.*, 690 F. Supp. 239, 245 (S.D.N.Y. 1988) (Other Def. Br. at 8), the court *sustained* plaintiffs' control person claims, based on plaintiff's allegations that defendants "encouraged and permitted the issuance of a press release that they knew was false." The court's only reservation was that *at trial* "plaintiff will have to demonstrate meaningful culpable conduct to recover under a 'controlling persons' theory." *Id.*

2. **The SCAC Sufficiently Alleges Culpable Participation**

The requirement to plead "culpable participation" in the Second Circuit as a separate element is far from settled. *In re Parmalat Sec. Litig.*, 373 F. Supp. 2d at 278, 308 (S.D.N.Y. 2005); *In re IPO Sec. Litig.*, 241 F. Supp. 2d 281, 395 (S.D.N.Y. 2003). *But see In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001); *Alstom*, 406 F. Supp. 2d at 489-90. There are a number of compelling reasons why culpable participation is *not* an element of an adequately pleaded control person allegation.

First, Section 20(a) on its face does not contain such a requirement. Once a plaintiff pleads a primary violation and "control" the burden shifts to the defendant to demonstrate "good faith" (or, a lack of culpable liability). Reading a "culpable participation" element into the affirmative claim makes the affirmative defense established by Congress redundant.

Second, the Second Circuit has not definitively ruled on whether "culpable participation" need be pled as an element to Section 20(a). Rather, its rulings indicate that although proof of culpable participation is relevant to a control person claim, the burden of that proof is not necessarily on plaintiff, but may be contained in the affirmative defense of good faith. *See First Jersey Sec., Inc.*, 101 F.3d at 1472-73; *Marbury Mgmt. Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973). Similarly, although the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 28 (1976) stated that Section 20(a) is among the provisions of the Exchange Act that "contains a state-of-mind condition requiring something more than negligence," that reference was to the affirmative defense whether the defendant "acted in good faith" (*id.*) and should not be read as imposing a separate element on the claim that is not contained in the statute.

Third, almost every other Circuit that has addressed the issue has ruled that culpable participation is not an element of the control person claim.[39] Significantly, the Fourth Circuit, which this Court cited in *Livent* as requiring culpable participation, 151 F. Supp. 2d at 414, 6, recently followed the Tenth Circuit and held that culpable participation is not an element of a control person claim. *See In re Mutual Funds Inv. Litig.*, 566 F. 2d 111, 129-30 (4th Cir. 2009).

Even if required as an element of the claim, the SCAC sufficiently pleads culpable participation. Although courts in this Circuit are split on whether the applicable pleading

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[39] *See Brody v. Stone & Webster, Inc. (In re Stone & Webster, Inc., Sec. Litig.)*, 424 F.3d 24, 26 (1st Cir. 2005) (noting "that § 20(a) does not on its face require the plaintiff to prove any state of mind of the defendant") (footnote omitted); *Wiggins v. Janus Capital Group, Inc. (In re Mut. Funds Inv. Litig.)*, 566 F.3d 111, 129-30 (4th Cir. 2009) (internal quotations omitted) (finding that to prove a *prima facie* case plaintiff "must allege: (1) a predicate violation of § 10(b) and (2) control by the defendant over the primary violator" and that "[o]nce the plaintiff establishes the prima facie case [of control], the burden shifts to the defendant to show lack of culpable participation or knowledge."); *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990) *citing G.A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981) ("Once a prima facie case is made, defendants can avoid liability by affirmatively proving that their supervision was adequate and that they did not know of the conduct of the Section 12 violator nor could they have reasonably known of it."); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 696-97 (6th Cir. 2004) (finding only two elements to prima facie case for control liability: (1) "the 'controlled person' must have committed an underlying violation of the securities laws or the rules and regulations promulgated thereunder" and (2) "the 'controlling person' defendant in a Section 20(a) claim must have directly or indirectly controlled the person liable for the securities law violation"); *Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609, 614 (7th Cir. 1996) (internal quotations omitted) ("[W]e have never used any test similar to the culpable participant test, as the district court had done in that case, to so stingily limit the definition of control person."); *Owens v. Miller (In re Miller)*, 276 F.3d 424, 431 (8th Cir. 2002) ("I note that § 20(a) contains a good faith exception to control person liability."); *Paracor Fin., Inc. v. GE Capital Corp.*, 96 F.3d 1151, 1161 (9th Cir. 1996) (internal citations omitted) ("The plaintiff need not show the controlling person's scienter or that they 'culpably participated' in the alleged wrongdoing."); *Maher v. Durango Metals*, 144 F.3d 1302, 1305 (10th Cir. 1998) (internal quotations omitted) ("This court has expressly 'rejected those decisions that may be read to require a plaintiff to show the defendant actually or culpably participated in the primary violation.'"); *Laperriere v. Vesta Insurance Group*, 525 F.3d 715, 723 (11th Cir. 2008), *quoting Thompson*, 636 F.2d at 960, ("What would be the purpose of the controlling person provision if intent were required – the provision would hardly make anyone liable who would not be so otherwise."). In the Third Circuit, although *Rochez Brothers, Inc. v. Rhoades*, 527 F. 2d 883 (3d Cir. 1975) has been cited for the proposition that "culpable participation" is an element of a Section 20(a) claim, the opinion arose after trial and the Court's language in context did not indicate that plaintiffs failed to withstand their burden of proof of "culpable participation" so much as that defendants withstood their affirmative defense of "good faith."

standard is that found in Fed. R. Civ. P. 8(a) or the more rigorous standard under Rule 9(b),[40] under either standard the SCAC has adequately pleaded a control person claim. Indeed, given the many district court[41] and Circuit court[42] decision that have rejected "culpable participation" in whole or in part, at a minimum, the "culpable participation" element ought to be applied in a manner that liberally allows pleadings.

Culpable participation may be established by pleading that "the controlling person knew or should have known that the primary violator was engaging in fraudulent conduct, or that the controlling person failed to review or check information that he or she had a duty to monitor, or that the controlling person ignored obvious signs of fraud." *Alstom*, 406 F. Supp at 491-92. Here, the Controlling Defendants' knowledge that FGG was responsible for $7 billion in investments, but lacked fundamental information regarding Bernard Madoff, is more than sufficient to establish culpable participation. *See Alstom,* 406 F. Supp. 2d at 496 (sustaining

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[40] Compare *In re Marsh & McLennan Cos. Sec. Litig.*, 501 F. Supp 2d at 494, with *Hall v. The Children's Place Retail Store, Inc.*, 580 F. Supp. 2d 212, 234-35 (S.D.N.Y. 2008). *See also Cornwell v. Credit Suisse Group*, 2010 WL 537593, at *23 (holding that culpable participation need be pled as an element of a Section 20(a) claim, but can be pled in accordance with Rule 8(a). Under Rule 8(a), plaintiffs must plead only "sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1940 (2009) (*quoting Twombly*, 550 U.S. at 570).

[41] *See generally In re Vivendi*, 381 F. Supp. 2d at 189 ("Courts in this district have adopted various standards to plead culpable participation" (collecting cases)); *Mishkin v. Ageloff*, 1998 WL 651065, at *22 (S.D.N.Y. 1988) ("Although one would think, and hope, that the standard to be applied to a motion to dismiss a section 20(a) claim is well-established, the opposite is all too unfortunately the case." (collecting cases)). Some courts have read the Second Circuit's decisions to mean that a plaintiff "need not affirmatively plead scienter on the part of a control person" in order to survive a motion to dismiss a section 20(a) claim. *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC.*, 446 F. Supp. 2d 163, 189-90 (S.D.N.Y. 2006) (citing *In re IPO Sec. Litig.*, 241 F. Supp. 2d at 395-96), accord *In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428, 439-41 (S.D.N.Y. 2006); *In re LaBranche Sec. Litig.*, 405 F. Supp. 2d 333, 363-64 (S.D.N.Y. 2005); *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. at 420 (holding no heightened pleading standard for section 20(a) claims; once plaintiff successfully pleads an underlying section 10(b) claim, then without more, "those who control that violator may be sued too"). Instead, at the pleading stage, these cases only require section 20(a) control liability to be alleged in accordance with Rule 8(a). *See, e.g., Lapin v. Goldman Sachs*, 506 F. Supp. 221, 245-46 (S.D.N.Y. 2006) (citing *In re WorldCom*, 294 F. Supp. 2d at 415).

[42] *See* note 39, *infra*.

allegations of culpable participation where the "division" at issue "was extremely important to [the company's] overall profile and liquidity . . . and the vendor financing arrangements were large in scope and extended over a significant length of time."); *Epstein v. Haas Sec. Corp.*, 731 F. Supp. 1166, 1175 (S.D.N.Y. 1990) (denying summary judgment to defendant on the issue of control person liability, on grounds, among other things, that the defendant was a member of Rothschild's executive committee: "[t]here is additional testimony to the effect that as a matter of practice committee members would report to the committee about their areas of responsibility, discussions of these matters would ensue and a collective decision would eventually be made.")

Internal FGG emails demonstrate that the Controlling Defendants were aware of FGG's lack of due diligence and knowledge of Madoff's operations. SCAC ¶ 207. For example, in response to a May 2008 client request, the Controlling Defendants were unable to provide information concerning such basic matters as account segregation, audits, and trade confirmations; recognizing that "[u]nfortunately there are certain aspects of [Madoff's] operations that remain unclear." *See* email from Vijayvergiya to Murphy, Piedrahita, Toub, Tucker, the Executive Committee and others, Aug. 19, 2008. SCAC ¶ 228.

On September 22, 2008, over a dozen years into FGG's relationship with Madoff, Landsberger sent an email to Vijayvergiya, Tucker and the other members of the Executive Committee (Piedrahita, Smith, and Murphy), asking "[c]an we get some clarity from BLM on how he sees the markets and liquidity from his counterparties on the options?" SCAC ¶ 208. Vijayvergiya responded to Smith, Landsberger, Tucker, Lipton, and the "Executive Committee" (including defendant Piedrahita) that:

> "[w]e have a number of questions for BLM relating to the derivatives [counterparties] – including his views on the willingness of the options [counter-parties] that have been historically used to continue trading with BLM, as Agent in this environment. These are in addition to several other important questions we

> have for BLM relating to their operations and trading (Bernie has already been sent a fax of our questions). [M]y preference would be to approach Bernie with well thought out, reasoned questions that focus on filling the gaps in our knowledge."

Yet Defendants never obtained this crucial information SCAC ¶¶ 209. And, thus, as late as May 2008 Defendant Vijayvergiya conceded in an email "[u]nfortunately there are certain aspects of [Madoff's] operations that remain unclear." SCAC ¶ 228.

The SCAC alleges conduct and knowledge of the Controlling Defendants to support the "culpable participation" element, and thus sufficient to establish a claim of control person liability.

II. PLAINTIFFS PROPERLY ALLEGE COMMON LAW TORT CLAIMS

A. New York Law Applies to Plaintiffs' Common Law Tort Claims

New York law should govern the state law claims of investors in the Fairfield Sentry and Sigma Funds. As this court is sitting in New York, New York choice-of-law rules apply. *See Arochem Int'l, Inc. v. Buirkle*, 968 F.2d 266, 269-70 (2d Cir. 1992) (citing *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. U.S. 487, 496 (1941)). For tort claims, New York follows an "interest analysis" that applies the law of the jurisdiction with the greatest interest in the litigation. *Arochem*, 968 F.2d at 270; *Int'l Planning, Ltd. v. Daystrom, Inc.*, 200 N.Y.S. 2d 817 (1969). Where, as here, "a number of countries have limited and dispersed contacts with the fraud, the court should apply New York law as the jurisdiction where the fraud originated and where substantial activities in furtherance of the fraud were committed." *Cromer Fin. v. Berger*, 137 F. Supp. 2d 452, 492-93 (S.D.N.Y. 2001). *See also Allstate Ins. Co. v. Hague*, 449 U.S. 302, 308 (1981) ("[A] set of facts giving rise to a lawsuit, or a particular issue within a lawsuit, may justify, in constitutional terms, application of the law of more than one jurisdiction. As a result, the forum State may have to select one law from among the laws of several jurisdictions having

some contact with the controversy.") (internal citations omitted).

In this case, it would be illogical (and impractical) for the court to apply the law of each Plaintiffs' domicile, as Plaintiffs are located throughout the world. Likewise, there is no compelling argument for the application of BVI law where the funds in question have "little more than a nominal connection to the BVI". *See Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec.*, LLC, 446 F. Supp. 2d 163, 194 (S.D.N.Y. 2006). The Sentry and Sigma Funds were organized under BVI law, but the only activity the funds conducted in the BVI was maintaining a registered agent there. *See* Hunte Aff. ¶ 30. The funds were not permitted to sell shares in the BVI. *Id.* The Funds had no employees in the BVI. *See* Fairfield Sigma Directors' Report (SCAC Ex. 20); Fairfield Sentry Directors' Report (SCAC Ex. 21). The Funds' directors never held any meetings in the BVI, and there were never any shareholders meetings. *See* Finkel Decl. ¶ 23.[43] Simply put, nothing was done in the BVI. Conversely, a substantial part of the events and actions of the Defendants giving rise to Plaintiffs' claims occurred within New York. The Fairfield Greenwich Group has offices in New York, extensive activities of Madoff took place in New York and – a key fact not mentioned in Defendants' Memorandum – the Sentry and Sigma Fund subscription agreements contain both a New York choice of law provision and New York forum selection clause.

In such instances, New York courts have routinely applied New York law. In *Cromer*, Judge Cote applied New York law to claims of a class of international investors, reasoning that while the injury to the widely dispersed plaintiffs "occurred in locations with only limited connection to the conduct at issue . . . a substantial portion of the fraudulent conduct . . . occurred in New York." 137 F. Supp. 2d at 492. *Pension Committee, supra,* is also instructive. There,

[43] On non-substantive matters such as jurisdiction and choice of law, the court may consider submissions outside of the complaint. *See, e.g., In re Livent, Inc. Securities Litigation*, 78 F. Supp. 2d 194, 200 (S.D.N.Y. 1999) (considering competing factual submissions on *forum non conveniens* motion).

investors brought suit to recover losses stemming from investments in two BVI hedge funds. Recognizing that the plaintiffs were an international group, that the defendants had extensive interaction with New York, and that the funds were defunct, Judge Scheindlin found that notwithstanding the "internal affairs doctrine," New York had the greatest interest in applying its law. Each of these points is equally applicable here. *See also Roselink Investors, L.L.C. v. Shenkman,* 386 F. Supp. 2d 209, 225 (S.D.N.Y. 2004) (applying New York law where a substantial portion of Defendants' conduct took place in New York and subscription agreements contained both a New York choice of law provision and New York forum selection clause); *Solow v. Stone*, 994 F. Supp. 173, 177 (S.D.N.Y.), *aff'd,* 163 F.3d 151 (2d Cir. 1998) (applying New York law to tort claims where acts giving rise to secondary claims occurred in significant part in New York).

To the extent that Defendants urge the application of BVI law based on the "internal affairs doctrine", they misapprehend the operation of that principle. Here, the internal affairs doctrine is inapplicable because Plaintiffs are not bringing claims against the directors of the Funds in which they purchased shares, but rather against the various FGG corporate entities and individuals responsible for the representations that led plaintiff to make and maintain those investments. *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) ("The internal affairs doctrine applies to those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders"); *Roselink Investors, L.L.C.*, 386 F. Supp. 2d at 225; *Ackert v. Ausman,* 218 N.Y.S. 2d 814, 817 (Sup. Ct. 1961) (*quoting Blue v. Standard Coil Prod. Co.,* 117 N.Y.S.2d 858, 860 (Sup. Ct. 1952)) ("The internal affairs doctrine applies only to 'controversies among the stockholders inter se, or between stockholders as a group and the corporation.'"). In any case, the New York Court

of Appeals has rejected the automatic application of the internal affairs doctrine. *See Greenspun v. Lindley,* 369 N.Y.S. 2d 123, 126 (1975). Instead, the doctrine is just one consideration among many in the choice of law inquiry, the most important of which is New York's contacts with the dispute. *Id.*

With respect to the Greenwich Sentry Partnerships, which are organized under Delaware law, the Court need not conduct a choice-of-law analysis because, as discussed below, Delaware law and New York law are similar. *See Broome v. ML Media Opportunity Partners L.P.*, 709 N.Y.S. 2d 59, 60 (App. Div. 2000); *Williamson v. Koch,* 2007 WL 2175553 (N.Y. Sup. Ct. 2007). Although the partnership agreements are governed by Delaware law, there is no other contact with Delaware, and as in the *Roselink* case, New York has the greatest contacts and thus, the greatest interest in applying its own tort law.

B. Plaintiffs Properly Allege Claims of Common Law Fraud

The elements of common law fraud under New York law are: (1) a material representation or omission of fact; (2) made with knowledge of its falsity; (3) with scienter or an intent to defraud; (4) upon which the plaintiff reasonably relied; (5) with such reliance causing damage to the plaintiff. *See Healthcare Fin. Group, Inc. v. Bank Leumi USA*, 669 F. Supp. 2d 344, 348 (S.D.N.Y. 2009); *Trinity Bui v. Indus. Enter.*, 594 F. Supp. 2d 364, 371 (S.D.N.Y. 2009) (Marrero, J.); *Ross v. Louise Wise Serv., Inc.*, 836 N.Y.S.2d 509, 515 (2007).

With respect to the scienter element, it has long been the law that "heedlessness and reckless disregard of consequence may take the place of deliberate intention," particularly where, as here, defendants who have professional standing and knowledge make baseless statements. *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 112 (1938). Thus, the Court of Appeals has upheld liability "even where there is lacking deliberate or active fraud" –

> A representation certified as true to the knowledge of the [speaker] when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses . . . .

Id. Here the SCAC alleges in detail how the Fairfield Defendants (indeed, all Defendants) made repeated statements about their expertise and their careful professional oversight of every step of the investment process. They intended that Plaintiffs should rely on these statements in making their investments. As the Court of Appeals observed in *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 179 (1931): "Fraud includes the pretense of knowledge when knowledge there is none." *Id. See also Anglo-Iberia Underwriting Mgt. Co. v. Lodderhouse*, 224 F. Supp. 2d 679, 685-86 (S.D.N.Y. 2002) (Marrero, J.) (citing with approval to *State Street* and *Ultramares* and denying summary judgment where "no rational jury would find that Plaintiffs' reliance on the misinformation supplied by [two of the defendants] was unreasonable." *Id.*

Moreover, common law fraud claims are routinely upheld when based on the same underlying facts as viable 10b-5 causes of action. *See, e.g., Abbey v. 3F Therapeutics, Inc.*, 2009 WL 4333819, at *13 (S.D.N.Y. 2009) ("Because the Court finds that Plaintiff has sufficiently pled his claim for securities fraud pursuant to Section 10(b) and Rule 10b-5, the state law fraud claim is also supported by sufficient factual allegations"); *Fezzani v. Bear, Stearns & Co.*, 592 F. Supp. 2d 410, 423 (S.D.N.Y. 2008). Because Plaintiffs have adequately pled all of the necessary elements of their claims under Section 10(b) and Rule 10b-5 (*see* Section I, above), Plaintiffs also have stated claims for common law fraud.

C. Plaintiffs Assert Valid Claims for Breach of Fiduciary Duty

Plaintiffs assert a valid claim for breach of fiduciary duty against the Fairfield Defendants on behalf of investors in the Funds. SCAC ¶¶ 403-09 (Count 8). Defendants move to dismiss

this claim primarily on grounds that BVI law applies to Plaintiffs' claims with respect to Sentry and Sigma, and that Delaware law applies to Plaintiffs' claims with respect to Greenwich Sentry and Greenwich Sentry Partners. *See* FG Br. at 59-66; Other Def. Br. at 12-13. As discussed above, there are no compelling reasons for the application of either BVI or Delaware law, particularly when the funds bore only a nominal connection to the BVI and there are no discernable conflicts between the relevant New York and Delaware law. Furthermore, to the extent that Defendants' rely on the internal affairs doctrine, that reliance is entirely misplaced. *See* Section II. A, *supra.*[44] Plaintiffs' are not bringing claims against the directors of the funds in which they invested.[45] Rather, the relationship between Plaintiffs and Defendants was that between an investor and an investment adviser, its principals, and affiliated entities.[46]

Under New York law, a claim for breach of fiduciary duty requires: (1) the existence of a fiduciary duty between the parties, (2) a breach of that duty; and (3) damages resulting from that breach. *Pension Comm. I,* 446 F. Supp. 2d at 196-98.[47] Such a breach may be found in any case "in which influence has been acquired and abused, in which confidence has been reposed and

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[44] The cases cited by Defendants do not suggest otherwise. *See Druck Corp. v. The Macro Fund (U.S.) Limited,* 2007 WL 258177 (S.D.N.Y. Jan. 29, 2007) (applying internal affairs doctrine where shareholders brought multiple claims against the fund in which they invested); *Walton v. Morgan Stanley & Co.,* 623 F.2d 796 (2d Cir. 1980) (applying Delaware law to a derivative lawsuit on behalf of a Delaware corporation where choice of law was uncontested and not have impacted the outcome of the case); *Davimos v. Halle*, 2006 WL 859368 (S.D.N.Y. Mar. 31, 2006) (applying Delaware law to breach of fiduciary duty claim where plaintiffs argued Delaware law applied and choice of law was uncontested).

[45] Walter Noel is not named as a Defendant in his capacity as a director of FGBL.

[46] To the extent Defendants rely on exculpation provisions in the Delaware partnership agreements, the inadequacy of those arguments is addressed below.

[47] Claims of breach of fiduciary duty alleging a breach of a duty of care, disclosure, or loyalty are subject to the general pleading standards set out by Rule 8(a) of the Federal Rules of Civil Procedure, not the heightened standards of Rule 9(b) (even where fraud claims are asserted in other counts within the same complaint). *Rahl v. Bande*, 328 B.R. 387, 413 (S.D.N.Y. 2005).

betrayed." *United Feature Syndicate, Inc. v. Miller Features Syndicate, Inc.*, 216 F. Supp. 2d 198, 218 (S.D.N.Y. 2002) (*quoting Penato v. George*, 383 N.Y.S.2d 900, 904 (App. Div. 1976)).

Most recently, Justice Lowe of the Supreme Court, New York County found that Ezra Merkin, manager of another Madoff feeder fund "had fiduciary duties to his investors." *People v. Merkin,* 2010 NY Slip Op 50430U, at 11 (Sup. Ct. Feb. 8, 2010) at 20, 21 ("Merkin was the investment advisor and manager to the investors of all four of the funds, and he had complete discretion with regard to how the monies were invested. The relationship created by the Offering Documents imposed on Merkin a duty to act with care and loyalty independent of the terms of those agreements."). Other New York courts have reached the same conclusion. *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). Under either New York or Delaware law, Defendants offer no legitimate argument to the contrary.[48]

Here, the FFC Defendants acknowledged to Plaintiffs, in private placement memoranda and other written materials, that they had fiduciary obligations to monitor and safeguard Plaintiffs' investments. *See* SCAC ¶¶ 193-216 and 404. The controlling FGG partnership (SCAC ¶ 117), its corporate partners (FGL, FGBL, FGA, FRS, and FHC) (SCAC ¶¶ 118-23), the Individual Defendants (Noel, Tucker, Piedrahita, Vijayvergiya, Lipton, and McKeefrey) (SCAC ¶¶ 124-29), and the FGG Executive Committee members (Landsberger, Smith, and Murphy) (SCAC ¶¶ 130,133-34), all held themselves out to Plaintiffs as possessing the necessary expertise

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[48] The cases cited by Defendants, Other Def. Br. at 13 and FG Br. at 64, are either inapposite or lend support to Plaintiffs' claims. In *Brass v. Am. Film Techs., Inc.*, 987 F.2d 142 (2d Cir. 1993), the Second Circuit reversed the dismissal of plaintiffs' claims, holding that the defendant had superior knowledge and a duty to disclose that there was a two-year holding period in which public trading of the common stock at issue was prohibited. *See also Continuing Creditors' Comm. of Star Telecomms. Inc. v. Edgecomb,* 385 F. Supp. 2d 449, 466 (D. Del. 2004) (holding that plaintiffs pled no facts "supporting, even inferentially, a claim for breach of the fiduciary duty of loyalty."); *In re IT Group Inc.*, 2005 WL 3050611 (D. Del. Nov. 15, 2005) (dismissing certain fiduciary duty claims while sustaining others and emphasizing the liberal pleading standards of Fed. R. Civ. P. 8(a)).

to monitor the Madoff investments, and being actively engaged in such monitoring. *See* Section I. A. 3, *infra*. Relying on these representations, Plaintiffs entrusted their investments to Defendants. Rather than exercising due care and loyalty with respect to Plaintiffs and their investments, Defendants entirely disregarded and abdicated those responsibilities. Moreover, some Defendants, including members of the Executive Committee, are alleged to have been "aware of FGG's lack of knowledge of Madoff's operations." SCAC ¶¶ 207. Plaintiffs allege that the members of the Executive Committee, who "controlled the day-to-day operations of FGG and its corporate partners", SCAC ¶¶ 176, sent emails – both individually and as a defined email group ("ExecutiveCommittee@fggus.com"), concerning FGG's lack of due diligence. *See* SCAC ¶¶ 208, 209 and 228. Landsberger, Murphy, and Smith accepted the financial benefits of being members of an Executive Committee. They cannot now deny responsibility for FGG's failure of due diligence.

Plaintiffs, therefore, adequately state a claim for breach of fiduciary duty, the resolution of which is necessarily a question of fact that should not be resolved on a motion to dismiss. *See* *Musalli Factory for Gold & Jewelry v. JPMorgan Chase Bank*, 261 F.R.D. 13, 26 (S.D.N.Y. 2009) ("New York courts generally avoid dismissing a claim of breach of fiduciary duty . . . because it usually involves a question of fact: whether someone reposed trust and confidence in another who thereby gains a resulting superiority or influence."); *Abercrombie v. Andrew Coll.*, 438 F. Supp. 2d 243, 274 (S.D.N.Y. 2006) (whether a fiduciary duty exists "normally depends on the facts of a particular relationship, [and] therefore a claim alleging the existence of a fiduciary duty is not subject to dismissal").

D. Plaintiffs Have Properly Pled Negligent Misrepresentation

Plaintiffs have stated claims for negligent misrepresentation (Counts 5 and 6 of the SCAC) against the Fairfield Defendants. (*See* SCAC ¶¶ 379-94.) To state a negligent

misrepresentation claim, a plaintiff must allege that: (1) the defendant had a duty, as a result of a special relationship, to give correct information; (2) the defendant made a false representation that he or she should have known was incorrect; (3) the information supplied in the representation was known by the defendant to be desired by the plaintiff for a serious purpose; (4) the plaintiff intended to rely and act upon it; and (5) the plaintiff reasonably relied on it to his or her detriment. *Hydro Investors, Inc. v. Trafalgar Power Inc.*, 227 F.3d 8, 20 (2d Cir. 2000); *see also Healthcare Fin. Group*, 669 F. Supp. 2d at 344, 347 (Marrero, J.) (same). Plaintiffs' allegations in the SCAC amply satisfy these elements.

For purposes of negligent misrepresentation, Plaintiffs allege that the Fairfield Defendants[49] failed to properly inform investors about the selection and scrutiny of investment managers for the Funds and the Funds' past financial performance. (*See* SCAC ¶¶ 181-82, 185-86, 188-89, 194-96, 201-02, 213-14.).

As to the substance of the claims, the Fairfield Defendants make three main arguments against Plaintiffs' negligent misrepresentation claims: (1) failure to allege a special relationship (FG Br. at 54-57; Other Def Br. at 10-12); (2) the alleged false and misleading statements are "prospective" (FG Br. at 57); and (3) failure to allege that each Fairfield Defendant was

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[49] The Fairfield Defendants consist of the FFC Defendants, the corporate entity FHC and the three members of the Executive Committee other than Piedrahita (defendants Landsberger, Smith, and Murphy). As to the non-FFC Defendants, the SCAC contains no allegations of fraud. Thus, even if the Court were to adopt a heightened pleading standard as to the FFC Defendants, the claims for negligent misrepresentation against FHC, Landsberger, Smith and Murphy need only comply with the liberal pleading standards of Rule 8(a). *See In re Fuwei Films Securities Litigation*, 634 F. Supp. 2d 419, 436-37 (S.D.N.Y. 2009) (even where complaint "sounds in fraud" against fraud defendants, claims against those defendants who were not named in the fraud counts are not subject to the heightened pleading standard under Fed. R. Civ. P. 9(b)); *In re Axis Capital Holdings Ltd. Sec. Litig.*, 456 F. Supp. 2d 576, 597 (S.D.N.Y. 2006) (in complaint alleging both fraud and negligence theories, claims against underwriter defendants were not subject to a heightened pleading standard because the claims against the underwriters were limited to negligence).

negligent (*id.* at 57-58).[50] Each argument amounts to an unconvincing recasting of arguments these Defendants make elsewhere.[51] Notwithstanding Defendants' arguments, Plaintiffs' negligent misrepresentation allegations are more than adequate for the reasons discussed in this Point and in Plaintiffs' arguments addressing their federal securities and common law fraud claims. *See* Points I and II.B., *supra*.

1. The FGG Defendants Owed Plaintiffs a Duty and are In a "Special Relationship" With Them

By representing their special expertise with respect to investments generally and the Madoff Funds specifically, the Fairfield Defendants placed themselves in a position of trust with respect to the Plaintiffs.[52] Where a defendant seeks to "induce plaintiffs to invest" by holding itself out as possessing "unique or specialized expertise" it occupies "a special position of confidence and trust with [respect to] the injured party such that reliance on the negligent misrepresentation is justified." *Kimmell v. Schaefer*, 652 N.Y.S. 2d 715, 719-20 (1996) (finding special relationship where defendant corporate chairman and CFO induced plaintiffs' investment based on financial projections that he created). *See also Muller-Paisner v. TIAA*, 289 F. App'x 461, 466 (2d Cir. 2008) (finding a special relationship for purposes of a negligent

[50] The Fairfield Defendants assert that the negligent misrepresentation claims are barred by the economic loss doctrine. *See* FG Br. at 58-59. Defendants' economic loss arguments are unavailing, as explained in detail below. In a single paragraph, the Defendants also contend that the negligent misrepresentation claims are precluded for the same reasons that Plaintiffs' common law fraud and federal securities fraud claims are, namely, reliance on prohibited materials, reliance on purported omissions and a lack of loss causation (arguing that all losses were caused by the actions of BMIS). Plaintiffs' detailed responses to these arguments are set forth in the remainder of this section.

[51] The Fairfield Defendants also argue in an aside (FG Br. at 58) that Plaintiffs' negligent misrepresentation claims are barred by the exculpatory provisions of the IMAs. This argument is addressed in Section V, *infra*.

[52] "[T]he standard of a special relationship in the context of a negligent misrepresentation claim is less rigorous than that of a fiduciary duty" claim. *Musalli Factory for Gold & Jewellry v. JPMorgan Chase Bank*, N.A., 261 F.R.D. 13, 28 (S.D.N.Y. 2009).

misrepresentation claim where defendant represented in marketing materials that their investment products were backed by considerable infrastructure).

The SCAC alleges that the Fairfield Defendants, as reflected in the PPMs, COMs and other written materials, took on obligations to monitor and safeguard Plaintiffs' investments. (*See* SCAC ¶¶ 193-216 and 404). These obligations put the Defendants in a "special relationship" with the Plaintiffs, both as holders and purchasers, and now expose them to liability for negligent misrepresentation. The Defendants' obligations are also consistent with the holding in *Merkin,* 2010 NY Slip Op 50430U. The *Merkin* Court concluded (*id.* at 20, 21) that "Merkin . . . had complete discretion with regard to how the monies were invested. The relationship created by the Offering Documents imposed on Merkin a duty to act with care and loyalty independent of the terms of those agreements."[53]

The FGG Defendants were responsible for the statements made to investors that induced them to purchase interests in the Funds. (SCAC ¶¶ 117-29, 133-34, 180.) In such circumstances, claims for negligent misrepresentation are properly pled because the alleged misrepresentations included information that plaintiffs considered in making their decision to invest. *See* SCAC ¶ 181; *Century Pac., Hold Inc. v Hilton Hotels Corp.*, 528 F. Supp. 2d 206, 232 (S.D.N.Y. 2007) (special relationship exists where "defendants sought to induce" plaintiffs to purchase by making statements or providing information that the plaintiffs would rely upon). The FGG Defendants' misrepresentations were made for the specific purpose of inducing

[53] In a footnote, the FG Defendants make the conclusory assertion that "Plaintiffs have not even attempted to plead" the prerequisite privity or near privity with the Defendants required to bring a negligent representation claim. FG Br. at 55-56, n.43. As set forth above, *see* Section II. C, *infra*, Plaintiffs have pleaded facts sufficient to establish the requisite level of a privity-like relationship with the FG Defendants. That privity-like relationship is evidenced here by the FG Defendants' providing to Plaintiffs the information concerning the Funds, with the understanding that Plaintiffs would use that information in deciding whether to invest in the Funds. *See Sheldon v. Khanal,* 2009 WL 3233093, at *14 (E.D.N.Y. Sept. 30, 2009) (finding that a special relationship existed between selling property owner and real estate broker).

Plaintiffs to purchase or hold their interests in the Funds – there could be no other purpose for the statements providing information about the Funds' investment strategy, performance and FGG's due diligence. Where a defendant's misrepresentations induce a plaintiff to do something, the absence of a "preexisting" relationship is not exculpatory. *See Muller-Paisner*, 289 F. App'x at 466 (misstatements in materials provided in connection with sale of annuity provide basis for negligent misrepresentation claim). For those same reasons, and due to the Fairfield Defendants' superior information and purported "special expertise," they cannot escape liability by contending that the "negotiations" related to the purchase of investors' interests in the Funds were "arms-length." The "special relationship" element is clearly established in Plaintiffs' allegations.

2. <u>The FGG Defendants' Statements Were Not "Prospective"</u>

As demonstrated in detail in response to the Defendants' arguments seeking dismissal of the Section 10(b) Exchange Act claims, the statements supporting Counts 5 and 6 do not concern Defendants' future actions. The PPMs and COMs at issue contained material misrepresentations with respect to the (1) performance record of the Funds (*see, e.g.,* SCAC ¶¶ 188-89). The identified statements contained in those PPMs, and as pled in the SCAC, were not statements of "future" performance projections or prospective promises, but misrepresentations concerning then present facts; (2) FGG Defendants' processes to select managers (*see, e.g.,* SCAC ¶¶ 182, 201, 213-14), and (3) the FGG Defendants' scrutiny of existing investment managers (*see, e.g.,* SCAC ¶¶ 181, 185-86, 194-96, 202).

3. The FGG Defendants Were All Legally Responsible

Defendants contend that Plaintiffs' negligent misrepresentation allegations fail because they do not allege "how each FG Defendant was negligent." This argument is factually baseless.[54]

The Defendants were all part of a group that had responsibility for, and the ability to control the publication of, the PPMs and other documents containing the misrepresentations published to the Plaintiffs. (SCAC ¶¶ 117-29, 133-34, 180.) These Defendants, through the exercise of reasonable care, could have and should have prevented the identified misrepresentations. Additionally, Plaintiffs have alleged that each of the Individual Defendants (Noel, Tucker, Piedrahita, Vijayvergiya, Lipton, McKeffry, Landsberger, Smith, and Murphy) were aware of the lack of knowledge of Madoff's operations despite the assertions in the PPMs and other documents claiming to have performed due diligence on Madoff. (SCAC ¶¶ 207-16.) Accordingly, Plaintiffs have adequately alleged that all of the Fairfield Defendants were negligent in making the identified misrepresentations.

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[54] Defendants rely on *Simon v. Castello*, 172 F.R.D. 103 (S.D.N.Y. 1997) and *Landy v. Mitchell Petroleum Tech. Corp.*, 734 F. Supp. 608 (S.D.N.Y. 1990) in making this argument. Both are distinguishable. In *Simon* the Court found that allegations of merely being on the board which voted approval of the transaction at issue was not sufficient where there was no allegation as to whether or not the individual defendants actually voted for the transaction. *Simon*, 172 F.R.D. at 107. Here, Plaintiffs have alleged that each of the individual Defendants was in a position to control the dissemination of the PPMs and were aware of the misrepresentations within the PPMs. (SCAC ¶¶ 207-16). In *Landy* the Court actually did find that where the plaintiffs pled that certain defendants were "allegedly responsible for identifiable misrepresentations which, it is clearly averred, they knew were false" the allegations were sufficient in pleading "knowledge of the alleged falsehoods." *Landy*, 734 F. Supp at 620. The *Landy* court only dismissed claims against other defendants against whom plaintiffs had merely pled "guilt by association." *Id.* Again, here, the claims against the Defendants here are not allegations of "guilt by association" but allegations that each Defendant had the ability to control the information in the PPMs, and allowed the misrepresentations to be disseminated with the knowledge that they were not accurate.

4. The Negligent Misrepresentation Claims Are Not Barred by the Economic Loss Rule

The Fairfield Defendants err when they argue that Plaintiffs' negligent misrepresentation (and gross negligence) claims are barred by the economic loss rule. (FG Br. at 58-59.) In fact, "'[t]he long-standing rule is that recovery may be had for *pecuniary loss* arising from negligent misrepresentations where there is actual privity of contract between the parties, *or* a relationship so close as to approach that of privity.'" *Travelers Cas. & Sur. Co. v. Dormitory Auth. of N.Y.*, WL 1177715, at *4 (S.D.N.Y. May 19, 2005), *quoting Ossining Union Free Sch. Dist. v. Anderson LaRocca Anderson*, 541 N.Y.S. 2d 335, 338 (1989) (emphasis added).[55] "[I]t is well settled that the same conduct which may constitute the breach of a contractual obligation may also constitute the breach of a duty arising out of the relationship created by contract but which is independent of the contract itself." *Fraternity Fund.*, 376 F. Supp. 2d at 407-08.[56]

As discussed above the special relationship between Plaintiffs and the Fairfield Defendants arose out of the PPMs and IMAs through which the Defendants assumed obligations to monitor and safeguard the Plaintiffs' investments giving rise to an independent duty of care. Similarly, in *Fraternity Fund*, 376 F. Supp. 2d 385, the court held that tort claims by a fund's limited partners against the fund's general partner were not barred by the economic loss rule, notwithstanding the contracts between the general and limited partners, even though the tort

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[55] *See also Board of Managers of Astor Terrace Condominium v. Schuman, Lichtenstein, Claman & Efron*, 583 N.Y.S. 2d 398, 400 (App. Div. 1992) (finding trial "court thus should not have dismissed the negligence causes of action seeking damages for economic loss" where there was a "relationship approaching privity").

[56] *See also Sommer v. Federal Signal Corp.*, 583 N.Y.S. 2d 957, 962 (1992) (recognizing that tort claim may exist where the parties' relationship is formed initially by contract); *New York Univ. v. Cont'l Ins. Co.*, 639 N.Y.S. 2d 283, 287 (1995) (holding that "defendant may be liable in tort when it has breached a duty of reasonable care distinct from its contractual obligations," because a "tort obligation is a duty imposed by law . . . 'apart from and independent of promises made and therefore apart from the manifested intention of the parties' to a contract".).

claims and contract claim were "based on the same underlying conduct-*i.e.*, that defendants misrepresented NAVs." *Id.* at 407-8. The court reasoned that "the allegations are sufficient to show a relationship of trust and confidence that flows from, but is independent of, the agreement." *Id.*[57]

The FGG Defendants' citation of *Cherny v. Emigrant Bank*, 604 F. Supp. 2d 605 (S.D.N.Y. 2009) is not on point. In *Cherny*, the plaintiffs sued a bank for negligent misrepresentation when the email address which plaintiff used for online banking began receiving spam, due to the bank's dissemination of the email address in violation of a Consumer Privacy Policy. *Id.* at 607. The court found that plaintiff was limited to a contract claim because no actual injury or damages were alleged. *Id.* at 609-10.[58] Here, there is economic injury as well as the special relationship that gives rise to the level of privity necessary to recover economic (or pecuniary) losses under a negligent misrepresentation claim. Those allegations have been well pled and should be sustained.

E. Plaintiffs Properly Allege Gross Negligence

The Fairfield Defendants assert (FG Br. at 66-67) that Plaintiffs' gross negligence claim fails because Plaintiffs do not allege the requisite conduct to establish gross negligence. Gross negligence is an "extreme departure from the standards of ordinary care." A*MW Materials Testing, Inc. v. Town of Babylon*, 584 F.3d 436, 454 (2d Cir. 2009); *Colnaghi, U.S.A., Ltd. v.*

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[57] Furthermore, claims of unjust enrichment and requests for imposition of a constructive trust are distinct from any contractual claims and not barred by the economic loss rule, *see, e.g., ESI, Inc. v. Coastal Power Prod. Co.*, 995 F. Supp. 419, 435 (S.D.N.Y. 1998) (citations omitted), as are claims sounding in fraud, *see, e.g., Metral v. Horn*, 624 N.Y.S.2d 177 (App. Div. 1995).

[58] The other cases cited by defendants are similarly inapposite. In *Robin Bay Assocs. LLC v. Merrill Lynch & Co.*, 2008 WL 2275902 (S.D.N.Y. June 3, 2008) (cited at FG Br. at 58), *PPI Enters. (U.S.), Inc. v. Del Monte Foods Co.*, 2003 WL 22118977 (S.D.N.Y. Sept. 11, 2003) (cited at FG Br. at 58 & 59), and *GMA Accessories, Inc. v. ePartners Inc.*, 2008 WL 781188 (S.D.N.Y. Mar. 19, 2008) (cited at FG Br. at 59), the plaintiffs, unlike Plaintiffs here, had contracts with the defendants so they could bring direct breach of contract claims.

Jewelers Protection Servs., Ltd., 595 N.Y.S. 2d 381, 383 (1993) (gross negligence evinces "a reckless disregard for the rights of others"); *AT&T v. City of New York*, 83 F.3d 549, 556 (2d Cir. 1996) (to be liable for gross negligence, defendants must have made errors or omissions that constitute a "gross failure to exercise due care.")

Plaintiffs' allege that the Fairfield Defendants "grossly failed to exercise due care, and acted in reckless disregard of their duties," "failed to exercise the degree of prudence, caution, and good business practice that would be expected of any reasonable investment professional," and "failed to perform adequate due diligence before selecting BMIS as the Funds' execution agent for its SSC method , and before allowing BMIS to serve as sub-custodian for the Funds; failed to monitor Madoff and BMIS on an ongoing basis to any reasonable degree; failed to take adequate steps to confirm BMIS's purported account statements, transactions and holdings of Fund assets." (SCAC ¶ 397.) Plaintiffs further allege that "the Fairfield Defendants grossly failed to perform the due diligence that they recognized was essential, and that standard industry practice requires," "wholly disregarded the red flags that surrounded Madoff and that should have alerted them, as experienced investment professionals, to the need for heightened scrutiny," and "when concerns about Madoff were raised or questions were asked, Defendants purposefully gave false or obfuscated answers." (SCAC ¶ 183.) In addition, Plaintiffs have alleged that the Fairfield Defendants not only failed to perform due diligence and ignored red flags, but they also allege that "the Fairfield Defendants knowingly assisted Madoff in thwarting an SEC investigation into his operations." (SCAC ¶ 234.) Plaintiffs have alleged that "the Fairfield Defendants aided Madoff in deceiving the SEC" by following his "instructions on how to approach their [] testimony" to the SEC. (*Id.*)

Defendants point to *Baker v. Andover Assocs. Mgmt. Corp.*, Index No. 6179/09 (N.Y. Sup. Ct. Nov. 30, 2009), which dismissed a gross negligence claim where plaintiffs simply alleged missing red flags, failing to undertake fiduciary duties, and failing to perform appropriate due diligence. *Id.*, slip op at 27. However, as detailed above and throughout Plaintiffs' pleadings, Plaintiffs here have alleged far more, including that Defendants purposefully gave false or obfuscated answers when approached with questions and concerns regarding Madoff *and* thwarted an SEC investigation of Madoff. This conduct combined with Defendants' repeated false statements over many years concerning their own due diligence and monitoring of Madoff, including their knowledge of red flags clearly "'smacks' of intentional wrongdoing." *AT&T*, 83 F.3d at 556 (internal citation omitted).

Defendants' argument that Plaintiffs gross negligence claim is barred by the economic loss doctrine is also unavailing, as shown in Section II. D. 4, above. Accordingly, Plaintiffs' allegations of gross negligence are adequately pleaded.

F. Plaintiffs Have Standing to Assert State Law Tort Claims

Plaintiffs have standing to pursue each of their state law tort claims. Although Defendants attempt to obscure the fact, this action does not involve a lawsuit by shareholders against the fund in which they invested. Instead, this action pits investors against the promoters, managers and sponsors of the funds – FGG – who induced their investment in the funds through reckless and fraudulent representations, abdicated their fiduciary duties to those investors, and engaged in grossly negligent conduct that directly caused those investors to lose billions of dollars. As such, Plaintiffs clearly have standing.[59]

[59] Defendants standing argument is directed solely to certain of plaintiffs' state law claims. Defendants do not – and could not – argue that Plaintiffs lack standing to advance claims under federal securities law or for fraudulent or negligent misrepresentations under state law.

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

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[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]

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).

The SCAC 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.

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.)

[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.

(“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:

> 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

[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.

> 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]

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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").

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]

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

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[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.

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 for such claims in any event.[72]

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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."

[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

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 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

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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.

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 security, or a direct agreement to make such a purchase. *See* FG Br. at 20-22.[74] Here, by

[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).

[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

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 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.

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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.

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]

- 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.

[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).

- 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 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 –

[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.

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).

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

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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.

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. <u>SLUSA's "In Connection With" Requirement Is Not Met</u>

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 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

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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*.

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]

[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,

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