CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-1844

Auditor Liability in the Current Environment:

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RECENT DEVELOPMENTS IN PONZI SCHEME LITIGATION

Lawrence J. Zweifach
Sophia N. Khan

Gibson, Dunn & Crutcher LLP

Mr. Zweifach is a partner of Gibson, Dunn & Crutcher LLP. Ms. Khan is an associate at Gibson, Dunn & Crutcher LLP.

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I. INTRODUCTION

Within a period of one and one-half years, from September 2008 to December 2009, authorities discovered four of the largest Ponzi schemes in U.S. history. Most notorious among them is Bernard Madoff's Ponzi scheme of epic proportions, which in December 2008 was reported to have been conducted for more than 20 years and to have involved more than $65 billion in investor losses. Following the Madoff scandal in size and scale are the schemes of Tom Petters, the architect of a $3.7 billion, ten-year long fraud that came to light in September 2008; Robert Allen Stanford, whose scheme surfaced in February 2009 and is believed to have spanned ten years and involved $8 billion; and Scott Rothstein, who confessed in December 2009 to running a $1.2 billion Ponzi scheme.

These Ponzi schemes have spawned major litigation in courts in the United States and abroad. Each case has led to multiple criminal prosecutions—not only of the four individuals who are ultimately credited with designing the fraudulent schemes, but also of their employees, associates and, in some cases, auditors, who are alleged to have been their co-conspirators in executing the fraud. The SEC and state attorney generals' offices have also brought related civil lawsuits and, further, bankruptcy proceedings have been instituted on behalf of the now-bankrupt entities, with court-appointed trustees seeking to recover funds on behalf of the damaged investors. The massive investor losses in each of these four schemes have also given rise to a surge of hundreds of private lawsuits filed in state and federal courts throughout the United States and in Europe. In some cases, the targets of these lawsuits are the founders of the Ponzi schemes themselves, while in others, plaintiffs have targeted feeder funds, banks, investment advisors, audit firms and other parties who allegedly played a role in causing investors' losses.

Audit firms defending Ponzi scheme-related lawsuits have faced class, derivative and individual actions, alleging federal, state statutory and common law claims—with many firms simultaneously facing multiple actions containing overlapping claims filed by different plaintiffs in far-flung jurisdictions. Although these actions are still in the early stages of litigation, as discussed below, many of the courts before which these cases are pending already have issued important decisions in the area of auditor liability.

II. RECENT PONZI SCHEMES: PETTERS, STANFORD, ROTHSTEIN AND MADOFF

A. Tom Petters

In September 2008, the FBI raided Tom Petters' personal residence and company headquarters after learning from a co-conspirator that Petters had been running a major Ponzi scheme for the past ten years. Shortly thereafter, Petters was arrested and indicted. According to the evidence presented at his criminal trial, Petters and others induced investors to provide funds that they claimed would be used to purchase electronic merchandise for resale at a profit. In reality, no such purchases were made; instead, the investor money was used to pay off other investors and fund the perpetrators' lavish lifestyles. At the time of his trial, Petters' $3.7 billion Ponzi scheme was reported to be the largest in U.S. history.

Petters was found guilty by a jury in December 2009 and sentenced to 50 years in prison in April 2010.[1] Petters filed an appeal before the Eighth Circuit Court of Appeals that is currently pending. The appeal argues that the "media frenzy" surrounding the case prevented Petters from receiving an impartial trial and that a key witness committed perjury. In addition to the criminal case against Petters, criminal charges have also been brought against several of Petters' associates, including Deanna Coleman, who initially reported the scam to the government, Larry Reynolds, Michael Catain, and Robert White. They all pled guilty.

Also pending are a bankruptcy proceeding for Petters Group Worldwide,[2] an SEC action against Petters and one of his hedge fund clients who allegedly participated in the fraud[3] and numerous civil lawsuits, some of which include claims against auditors. In one such lawsuit, filed in the U.S. District Court for the District of Minnesota and brought by investors in a fund that was audited by McGladrey & Pullen, LLP, the complaint alleged that McGladrey "failed its duty" to "exercise due professional care, professional skepticism and objectivity, and to develop and follow procedures, analyses, and tests to verify the legitimacy and accuracy of the client's assets, liabilities,

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1. *United States v. Petters*, No. 0:08-cr-00364 (D. Minn.)
2. *In re Petters Group Worldwide, LLC*, No. 08-45258 (Bankr. D. Minn.)
3. *SEC v. Petters, et al.*, No. 09-cv-1750 (D. Minn.)

operations, and cash flow."[4] Further, the complaint alleged, "[h]ad it done its job, the partners of those funds would not be in the financial straits they find themselves in today." Based on these allegations, plaintiffs claimed that McGladrey committed professional negligence. Several months after the case was filed, however, it was voluntarily dismissed. Another lawsuit, filed in California state court and later removed to the U.S. District Court for the Northern District of California, named three auditor defendants: Rothstein Kass & Company, PC, McGladrey & Pullen, LLP and Ernst & Young LLC [sic]. Plaintiffs alleged that the auditor defendants "turn[ed] a blind eye to the deficiencies in the [general partners of the funds'] conduct" and thereby "knowingly provided substantial assistance to the General Partner Defendants' breaches of fiduciary duty."[5] The claim against the auditors was for aiding and abetting a breach of fiduciary duty. Further, in July 2010, the auditing firm Kaufman Rossin & Co. settled, without admitting liability, a malpractice lawsuit brought by the bankruptcy trustee for two of Kaufman Rossin's audit clients, hedge funds Palm Beach Finance Partners and Palm Beach Finance II. The amount of the settlement was $9.6 million.

B. Robert Allen Stanford

Robert Allen Stanford, Chairman of the Stanford Group, came under investigation for fraud by the Department of Justice and the SEC in early 2009. Indictments and SEC civil complaints against him and several of his alleged co-conspirators followed. According to the charges, for at least ten years, Stanford sold fraudulent certificates of deposit in his bank, Stanford International Bank, by lying to investors about the rates of return they could expect on their investments while actually operating an $8 billion Ponzi scheme.[6] Stanford pled not guilty to the criminal charges against him, and the case is expected to proceed to trial in January 2011. Among the others criminally charged, only one—the former Chief Financial Officer—admitted guilt. The SEC

4. *Ellerbrock Family Trust, LLC v. McGladrey & Pullen, LLP*, No. 0:08-cv-05370 (D. Minn. filed Oct. 6, 2008)
5. *Tuttle v. Sky Bell Asset Mgmt. LLC*, No. 3:10-cv-03588 (N.D. Cal. removed Aug. 13, 2010)
6. *United States v. Stanford*, H-09-342 (S.D. Tex.); *SEC v. Stanford Int'l Bank*, No. 3-09-cv-0298-L (N.D. Tex.)

action against Stanford and his alleged co-conspirators has been stayed pending resolution of the criminal charges.

In addition to the governmental actions, numerous civil lawsuits have been filed against Stanford and his companies. A number of these cases have been consolidated for pre-trial proceedings by the Judicial Panel on Multidistrict Litigation and are currently pending in the United States District Court for the Northern District of Texas.[7]

Stanford was also engaged in an insurance coverage dispute in which he (and the other defendants who have been criminally and civilly charged in connection with his alleged Ponzi scheme) sought reimbursement of their defense costs under a D&O liability policy.[8] After the district court ordered reimbursement of the costs, the underwriters appealed to the Fifth Circuit Court of Appeals. The appeals court held that the underwriters were obligated to advance defense costs until the substantive boundaries of the coverage are determined.[9]

C. Scott Rothstein

The last of the recent, major Ponzi schemes to be discovered was that of Scott Rothstein, a Florida attorney. After fleeing the U.S. for a month when his scheme began to unravel, Rothstein returned in November 2009 and reportedly confessed to federal prosecutors. On December 1, 2009, he was arrested on a criminal information alleging racketeering, money laundering, and mail fraud and wire fraud.[10] According to the charges against him, Rothstein and his law firm deceived investors into purportedly buying shares in confidential settlement agreements in sexual harassment and whistle-blower actions. In reality, the settlements were non-existent, and the investor funds were used to perpetuate Rothstein's Ponzi scheme.

In January 2010, Rothstein pled guilty to all the criminal counts against him and, in June, he was sentenced to 50 years in prison. In addition to Rothstein, his law firm's Chief Operating Officer, Debra

7. *In re Stanford Entities Sec. Litig.*, No. 3:09-md-02099 (N.D. Tex.)
8. *Laura Pendergast-Holt v. Certain Underwriters at Lloyd's*, No. 4:09-cv-03712 (S.D. Tex.)
9. *Laura Pendergast-Holt v. Certain Underwriters at Lloyd's*, No. 10-20069 (5th Cir.)
10. *U.S. v. Rothstein*, No. 09-6033 (S.D. Fl. filed Dec. 1, 2009)

Villegas, pled guilty to criminal charges in June 2010 and is currently awaiting sentencing.

Meanwhile, Rothstein's law firm, Rothstein Rosenfeldt Adler, PA ("RRA"), is undergoing bankruptcy proceedings in the Southern District of Florida, which were initiated by four creditors in November 2009.[11] The bankruptcy trustee has brought suit against, among others, the accounting firm Berenfeld Spritzer Schecter & Sheer ("BSSS"), which allegedly performed tax work for Rothstein's law firm and accounting work for a major feeder fund to the fraud. The complaint against BSSS alleges that "BSSS became captivated by Rothstein's illusory wealth and the prospect of receiving lucrative engagements from Rothstein's personal corporate empire and his clients," and, thus that, it "look[ed] the other way" at Rothstein's fraud. It further alleged that "accountants at BSSS knew that the RRA financial picture simply made no sense," but that they "ignored numerous red flags." The complaint brought four counts against BSSS, alleging negligence, breach of contract, aiding and abetting a breach of fiduciary duty, and an objection to or equitable subordination of the Proof of Claim that BSSS filed against RRA's bankruptcy estate. According to the trustee, Berenfeld was responsible for $450 million in losses.

The Rothstein fraud has also given rise to civil lawsuits, most notably a 2,200-plus page complaint in Florida state court.[12] The lawsuit has been amended several times to add more plaintiffs, defendants and claims of wrongdoing. Among the defendants are numerous hedge funds and investment banks that allegedly worked with Rothstein in perpetrating his fraud. The auditing firm BSSS and several of its individual accountants are also named in the suit. The complaint alleges that BSSS employees were "the last line of defense that had the means and opportunity to expose the largest Ponzi scheme in Florida history," both because of its tax work for Rothstein and accounting work for a Rothstein feeder fund. Further, the complaint alleges that "[BSSS] employees elected to do nothing but intentionally or recklessly ignore a list of red flags as long as the list of victims."[13] In August 2010, it was reported that Rothstein has been

11. *In re Rothstein Rosenfeldt Adler, P.A.*, No. 09-34791-RBR (Bankr. S.D. Fla. filed Nov. 19, 2009)

12. *Razorback Funding LLC v. Rothstein*, CACE09062943 (Fla. Cir. Ct. Broward Co. filed Nov. 20, 2009)

13. http://southflorida.bizjournals.com/southflorida/stories/2010/04/19/daily37.html

cooperating with the plaintiffs' attorney and that Rothstein may testify against his alleged co-conspirators.

D. Bernard Madoff

In December 2008, federal investigators discovered what is thought to be the largest Ponzi scheme in history, reportedly spanning over twenty years and involving more than $65 billion in investor money. The scheme was orchestrated by Bernard Madoff, former investment advisor and the founder of Bernard L. Madoff Investment Securities, LLC ("BLMIS"). Madoff's fraud has spun a complex web of litigation, ranging from criminal prosecutions of Madoff and those who allegedly participated in or otherwise assisted his fraudulent scheme, to parallel civil proceedings brought by the SEC and private parties, investigations and lawsuits by state attorney generals, and complex bankruptcy proceedings. Most significantly for auditors, investors who allegedly lost money to Madoff have filed numerous private civil lawsuits throughout the United States and Europe, seeking to recover from the funds and banks who advised them or invested their money, as well as from those entities' auditors. Commensurate with its scale, the Madoff scheme—when compared to other recent Ponzi schemes—has resulted in the broadest range and widest variety of litigation. As discussed below, courts before which the Madoff-related litigation is pending have issued very significant decisions in enforcement proceedings and private actions.

1. Criminal Proceedings Against Madoff and Madoff's Employees and Alleged Co-Conspirators

On December 11, 2008, Bernard Madoff was arrested on a criminal complaint alleging securities fraud. The Department of Justice's criminal information against Madoff, filed on March 10, 2010 in the U.S. District Court for the Southern District of New York, contained eleven felony charges, including securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of money laundering, false statements, perjury, false filings with the SEC and theft from an employee benefit plan.[14] On March 11, 2010, Madoff pled guilty to all eleven charges and was

14. *United States v. Madoff*, No. 08 MAG 2735 (S.D.N.Y. filed Dec. 11, 2008)

subsequently sentenced to a 150-year prison term, which he is currently serving.

Certain employees of BLMIS, who allegedly helped conceal and further Madoff's fraudulent scheme, have also faced criminal charges. One such individual is Frank DiPascali, a long-time aide of Madoff and the Chief Financial Officer of BLMIS, who in August 2009 pled guilty to ten felony counts including conspiracy, fraud and money laundering. DiPascali now faces up to 125 years in prison. He also admitted the two criminal forfeiture allegations against him and consented to a total money judgment in the amount of $170.25 billion. DiPascali has agreed to cooperate with federal prosecutors in the hope of receiving leniency when he is sentenced.[15]

Federal prosecutors also brought criminal charges against Jerome O'Hara and George Perez, employees of and computer programmers at BLMIS, and Daniel Bonventre, Director of Operations at BLMIS. O'Hara's and Perez's lawyers have stated that they will contest the charges against them, including charges of conspiracy, falsifying records of a broker dealer and falsifying records of an investment adviser. The complaint against Bonventre stated charges for conspiracy, securities fraud and tax charges; further, it also implicated Madoff's family members, without naming them specifically, leading to speculation that they may also be criminally charged.

Further, David Friehling of Friehling & Horowitz CPA's, PC, the independent auditor of BLMIS, was criminally charged in March 2009 with securities fraud, aiding and abetting investment adviser fraud, and filing false audit reports to the SEC.[16] Charges of obstructing the administration of federal tax laws were added later. Friehling pled guilty to all the charges against him in November 2009, admitting that he rubber-stamped Madoff's filings but insisting that he did not know about the Ponzi scheme. He faces up to 114 years in prison and has agreed to cooperate with prosecutors in the hope of receiving a lenient sentence.

Most recently, in June 2010, federal prosecutors filed civil forfeiture complaints against two of Madoff's long-time back

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15. *United States v. DiPascali*, No. 1:09-cr-00764-RJS (S.D.N.Y. filed Aug. 11, 2009)
16. *United States v. Friehling*, No. 1:09-cr-00700-AKH (S.D.N.Y. filed March 17, 2009)

office employees, Annette Bongiorno and JoAnn Crupi, seeking $5 million in assets.[17] The complaints allege that each defendant "knowingly perpetrated the fraud," but no criminal charges have yet been brought against either Bongiorno or Crupi.

2. *SEC Actions Against Madoff and Madoff's Employees and Alleged Co-Conspirators*

In addition to the criminal prosecution of Madoff, the SEC also filed a civil complaint against Madoff in the U.S. District Court for the Southern District of New York.[18] The complaint alleged that Madoff had admitted to his employee(s) that he had been conducting a Ponzi scheme, that BLMIS was broke, and that he had planned to distribute any remaining funds to employees, family, and friends. The complaint further stated that emergency relief was needed "[t]o halt the ongoing fraud, maintain the status quo, and preserve any assets for injured investors." Thus, the complaint brought claims for violations for the Advisers Act, the Securities Act, and the Exchange Act. Madoff partially settled the SEC's charges against him, pursuant to an agreement that bans him from violating securities laws and from working with any broker, dealer, or investment advisor. Madoff neither admitted nor denied the charges against him.

The SEC also brought civil parallel proceedings against the same Madoff employees who were criminally charged, including Frank DiPascali, Jerome O'Hara, George Perez, Daniel Bonventre and David Friehling:

- DiPascali was charged with seven causes of action, including violations of Section 17 of the Securities Act; violations of Section 10(b) of the Exchange Act; and aiding and abetting violations of the Exchange Act and the Advisers Act.[19] Shortly after the complaint was filed in August 2009, DiPascali consented to a partial judgment imposing a permanent injunction against him, restraining him from violating certain antifraud provisions of the federal securities laws.

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17. *United States v. $304,041.01 on Deposit at Citibank, N.A.*, No. 10-cv-4858 (S.D.N.Y. filed June 22, 2010); *United States v. 1081 Barnegat Lane, Mantoloking, new Jersey, 08738*, No. 10-cv-4857 (S.D.N.Y. filed June 22, 2010)
18. *SEC v. Madoff*, No. 08-cv-10791 (LLS) (S.D.N.Y. filed Dec. 11, 2008)
19. *SEC v. Di Pascali*, No. 09-cv-7085 (S.D.N.Y. filed Aug. 11, 2009)

- O'Hara and Perez were charged with five causes of action for aiding and abetting violations of sections of the Exchange Act and the Advisers Act.[20] The defendants filed their answers to the SEC's complaint in May 2010 and the parties have commenced discovery.
- Bonventre was charged with seven causes of action, including violations of Section 17 of the Securities Act; violations of 10(b) of the Exchange Act; and aiding and abetting violations of the Exchange Act and the Advisers Act.[21] He filed his answer to the complaint in May 2010 and the parties have started discovery.
- Friehling and Friehling & Horowitz were charged with six causes of action for violations of Section 17 of the Securities Act; violations of Section 10(b) of the Exchange Act; and aiding and abetting violations of the Exchange Act and the Advisers Act.[22] In November 2009, defendants consented to a partial judgment imposing permanent injunctions against them, restraining them from violating certain antifraud provisions of the federal securities laws.

Further, the SEC brought several actions against major Madoff feeder funds. One such action was against Stanley Chais, an investment advisor in California and a close friend of Madoff, who was the founder and general partner of three of the largest Madoff feeder funds.[23] The complaint alleged that Chais misrepresented to investors that he was actively managing their money; instead, he was really channeling it to Madoff without making any actual investment decisions. In addition, according to the complaint, Chais instructed Madoff not to report any losses on any of the funds' individual trades. The complaint alleged that Madoff complied with Chais' request and did not report a loss on a single equities trade purportedly made with the funds' investments for almost ten years—this allegedly was "a glaring red flag that should have made clear to Chais that Madoff's reports to Chais were false." Four causes of action were stated in the complaint,

20. *SEC v. Perez, O'Hara*, No. 09-cv-9425 (S.D.N.Y. filed Nov. 13, 2009)
21. *SEC v. Bonventre*, No. 10-cv-1576 (S.D.N.Y. filed Feb. 23, 2010)
22. *SEC v. Friehling*, No. 09-cv-2467 (S.D.N.Y. filed March 18, 2009)
23. *SEC v. Chais*, No. 09-cv-5681 (S.D.N.Y. filed June 22, 2009)

including violations of Section 17 of the Securities Act; violations of Section 10(b) of the Exchange Act; and violations of the Advisers Act. The action was stayed by the court pending a resolution of the parallel criminal investigation.

Another feeder fund sued by the SEC for its involvement in the Madoff fraud was Cohmad Securities Corporation, a fund that was allegedly jointly founded by Madoff and Maurice Cohn and jointly owned by individuals in the Madoff family, the Cohn family and two other individuals.[24] The complaint alleged that Cohmad was "BLMIS's in-house marketing arm," which raised billions of dollars for the Ponzi scheme, and that the defendants "knowingly or recklessly" participated in Madoff's fraud. Eight causes of action were stated in the complaint, including violations of Section 17 of the Securities Act; violations of Section 10(b) of the Exchange Act; and aiding and abetting violations of the Exchange Act and the Advisers Act. In February 2010, the court granted in part and denied in part defendants' motions to dismiss; he also granted the SEC leave to amend the complaint. With respect to the securities fraud claims, the court found that "[n]owhere does the complaint allege any fact that would have put defendants on notice of Madoff's fraud." It found that defendants' fraudulent intent could not be inferred from compensation agreements, compliance with Madoff's requests for secrecy, regulatory violations, or "irregularities" in one defendant's personal account with BLMIS. On the other hand, some of the claims for aiding and abetting regulatory violations survived the motion to dismiss. The SEC's amended complaint is due in October 2010.

3. State Attorney General Proceedings Against Madoff Feeder Funds

In addition to receiving SEC scrutiny, Madoff feeder funds have also been targeted in lawsuits brought by state attorney generals. For example, in April 2009, the Securities Division of the Secretary of the Commonwealth of Massachusetts filed an administrative complaint against Fairfield Greenwich Advisors LLC for violations of the Massachusetts Uniform Securities Act.[25]

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24. *SEC v. Cohmad Secs. Corp.*, No. 09-cv-5680 (S.D.N.Y. filed June 22, 2009)
25. *In re Fairfield Greenwich Advisors LLC*, No. 2009-0028 (filed Apr. 1, 2009)

The complaint alleged “a profound disparity between the due diligence Fairfield represented to its investors that it would conduct with respect to [BLMIS] and the due diligence it actually conducted.” It also alleged “the lack of an arms-length relationship between Fairfield and [BLMIS] and the failure of Fairfield to disclose to investors the interconnected relationship.” In September 2009, a consent order was issued in which defendants, while neither admitting nor denying the allegations, agreed to permanently cease violating the Massachusetts Uniform Securities Act and agreed to pay a civil penalty of $500,000. Defendants also agreed to provide certain amounts in restitution to investors.

In New York, Attorney General Cuomo brought two similar lawsuits. The first, filed in April 2009, was against Ezra Merkin.[26] The complaint alleged that Merkin and his investment management company deceived investors by making them think he was actively managing their accounts when he was actually channeling their money to Madoff. The complaint stated claims under New York’s Martin Act; Executive Law; and Not-for-Profit Corporation Law, as well as a common law claim for breach of fiduciary duty. Defendants moved to dismiss, and the New York State Supreme Court denied the motion in February 2010. With respect to the claims under the Martin Act and the Executive Law, the court found that “Merkin’s representations, as alleged in the pleadings, were fraudulent and his omissions were material” and that dismissal, therefore, was inappropriate. The court further found that the allegations of breaches of fiduciary duty were sufficiently specific to support the claims under the Not-for-Profit Corporation Law and for breach of fiduciary duty. Defendants filed their answers to the complaint in April 2010.

In May 2010, Attorney General Cuomo filed a lawsuit against Ivy Asset Management, LLC.[27] The complaint alleges that defendants, an investment advisory firm and two of its senior managers, learned troubling information about Madoff but chose to conceal this information from certain investor clients and affirmatively misled them so that the clients would continue to invest with Madoff. The complaint also alleges that at the same time, the

26. *Cuomo v. Merkin*, No. 450879/2009 (Sup. Ct., N.Y. Co., filed Apr. 6, 2009)
27. *Cuomo v. Ivy Asset Mgmt., LLC*, No. 450789/2010 (Sup. Ct., N.Y. Co., filed May 11, 2010)

defendants reduced their own Madoff investment and advised other investors to refrain from investing with Madoff. The complaint brings claims under New York's Martin Act and Executive Law, as well as a common law claim for breach of fiduciary duty.

4. Bankruptcy Proceeding for the Liquidation of BLMIS

a. Securities Investor Protection Act and Procedural Posture of Madoff Bankruptcy Proceeding

The BLMIS bankruptcy proceeding falls under the statutory framework of the Securities Investor Protection Act ("SIPA").[28] SIPA was enacted in 1970 "for the primary purpose of protecting customers from losses caused by the insolvency or financial instability of broker-dealers."[29] In SIPA-governed bankruptcy proceedings, a fund of "customer property" is established—generally by pooling the debtor firm's securities and cash—for distribution among the debtor's customers, with each customer being entitled to share in this fund *pro rata* to the extent of his or her Net Equity. SIPA also created the Securities Investor Protection Corporation ("SIPC"), which is charged with establishing and administering a SIPC fund to advance money to the SIPA trustee in order to promptly pay each customer to the extent that his or her Net Equity claim exceeds his or her ratable share of customer property, up to $500,000 per customer.

On December 15, 2008, days after the Madoff fraud was uncovered, SIPC filed an application in the *SEC v. Madoff* action pending in the Southern District of New York, seeking a decree that the customers of BLMIS are in need of the protections afforded by SIPA.[30] The court granted SIPC's application and issued an order placing BLMIS's customers under the protections of SIPA; appointing Irving H. Picard as Trustee for the liquidation of BLMIS pursuant to SIPA; and removing the SIPA liquidation proceeding to the bankruptcy

28. 15 U.S.C. § 78aa.
29. *In re Bernard L. Madoff Inv. Secs. LLC*, 424 B.R. 122, 132 (Bankr. S.D.N.Y.).
30. *In re Bernard L. Madoff Inv. Secs. LLC*, 424 B.R. 122, 126 (Bankr. S.D.N.Y.).

court.[31] That order imposed an automatic stay on claims against Madoff and BLMIS.[32] As of December 2008, BLMIS purportedly owed a total of $64.8 billion to customers.

On December 23, 2008, the bankruptcy court approved a framework for the filing, determination and adjudication of claims in the BLMIS liquidation proceeding.[33] Pursuant to that framework, BLMIS customers were required to file claims with the Trustee, who then was required to issue a written determination of each claim. If any claimant objected and filed an opposition to the determination, the Trustee was required to obtain a hearing date. On June 9, 2009, the bankruptcy court consolidated the BLMIS SIPA proceeding with the estate of Bernard L. Madoff.[34]

More than 15,000 SIPA claims have been filed. To date, approximately 13,189 claims have been determined. Of those, approximately 2,175 have been allowed and 11,014 have been denied. The total amount of the allowed claims is approximately $5.56 billion.[35]

The Trustee has filed numerous complaints domestically and internationally against various entities that were associated with, worked with, or invested with Madoff, seeking to recover funds from which to settle investor claims. In August 2010, the Trustee filed three lawsuits in Bankruptcy Court against entities affiliated with Madoff's family members, seeking to recover more than $30 million collectively and accusing them of taking nearly $200 million of investor money to fund their lavish lifestyles.

b. Definition of "Net Equity"

A major point of contention in the Madoff bankruptcy proceeding was the definition of "net equity" for purposes of determining the amount of money owed to claimants under SIPA. Certain claimants objected to the Trustee's method of

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31. http://www.madofftrustee.com/; http://www.madofftrustee.com/documents/signedorder_new.pdf
32. http://www.madofftrustee.com/documents/signedorder_new.pdf
33. *In re Bernard L. Madoff Inv. Secs. LLC*, 424 B.R. 122, 126 (Bankr. S.D.N.Y.).
34. http://www.madofftrustee.com/
35. http://www.madofftrustee.com/Status.aspx

determination of their claims. To settle this dispute, the bankruptcy court considered the issue of "how to define a claimant's 'net equity' under SIPA for purposes of distributing against these astounding sums."[36]

The Trustee argued that "net equity" is "the amount of cash deposited by the customer into his BLMIS customer account less any amounts already withdrawn by him (the 'Net Investment Method')."[37] Objecting claimants, on the other hand, sought to define net equity as "the amounts reflected on customers' November 30th [2008] Statements," the last account statement Madoff distributed before his arrest (the "Last Statement Method").[38] On March 1, 2010, the bankruptcy court ruled in favor of the Trustee's Net Investment Method. Specifically, the court held that the term "securities positions," as used in SIPA's definition of net equity, can only be determined by reviewing the debtor's books and records to determine actual securities positions held. Madoff's records revealed that no securities were ever purchased and that the only verifiable amounts in any customer's accounts were the cash deposited and withdrawn. The bankruptcy court also cited "equity and practicality" as a reason to endorse the Net Investment Method.[39] Thus, those Madoff victims who withdrew more cash than they deposited (the "Net Winners") will not receive a SIPC advance irrespective of whether they relied in good faith on the fact that their Madoff account statements reflected much larger fictitious securities positions.

On March 8, 2010, the bankruptcy court entered an order implementing its March 1st decision. Following the court's order, on March 8, 2010, the Trustee and some of the BLMIS claimants filed a joint request for the court to certify its order for direct appeal to the Second Circuit Court of Appeals, pursuant to 28 U.S.C. § 158(d)(2), under which "a bankruptcy court may certify an order for immediate appeal to a circuit court of appeal where the order 'involves a matter of public

36. *In re Bernard L. Madoff Inv. Secs. LLC*, 424 B.R. 122 (Bankr. S.D.N.Y.)
37. *Id.* at 125.
38. *Id.*
39. *Id.*

importance,' or where an appeal from the order 'may materially advance the progress of the case.'" If a court determines that those circumstances exist, certification is mandatory. In their request, the parties stated, "[a]s this liquidation proceeding affects a large number of customer claimants, and has generated Congressional hearings, proposed amendments to the United States Code, and sustained press coverage, we submit that this proceeding, and particularly the Net Equity Dispute, is a matter of public importance appropriate for certification to the Court of Appeals."[40]

The court granted the joint request and certified "that an immediate appeal of the Net Equity Order is appropriate because this proceeding involves a matter of public importance, and an immediate appeal may materially advance the progress of this proceeding."[41] Various investors have since filed notices of appeal with the Second Circuit Court of Appeals, asking the court to hear their challenge to the bankruptcy court's ruling.

c. Investor Lawsuit Against SIPC

In February 2010, a group of Madoff investors brought a class action lawsuit against the president and directors of SIPC, further challenging the "net investment" method of determining their claims.[42] The complaint alleges that they would not have invested in Madoff "but for the promise of SIPC insurance" and that the defendants deliberately misrepresented "the nature and scope of insurance" and thus "perpetrat[ed] a fraudulent investment insurance scheme which has resulted in billions of dollars of injury to class members. The complaint elaborates by stating that, "in direct contradiction of their repeated representations … and in violation of their statutory mandate, defendants have caused their designated trustee [Picard] to refuse to pay SIPC

40. March 8, 2010 Joint Letter Application to Judge Burton Lifland
41. March 8, 2010 Court's Certification of Net Equity Order of March 8, 2010 for Immediate Appeal to the Untied States Court of Appeals Pursuant to 28 U.S.C. § 158(d)(2)
42. *Canavan v. Harbeck*, No. 1:10-cv-05200 (S.D.N.Y. filed Feb. 24, 2010)

insurance to any Customer whose withdrawals exceeded his deposits, regardless of the amount of time the Customer maintained the account." Upon motion of the defendants, the District Court in New Jersey, where the action was filed, transferred the case to the Southern District of New York after determining that it was related to the bankruptcy proceedings there. Days after the transfer, over the plaintiffs' objection, the case was administratively closed by the court and was referred to the bankruptcy court.

d. Effect of Bankruptcy Proceeding on Other Proceedings

The commencement of a SIPA liquidation proceeding operates as an automatic stay of "the commencement or continuation … of a judicial, administrative, or other action or proceeding against the debtor" or "any act to otain possession of … or to exercise control over property of the estate." 11 U.S.C. § 362(a)(1), (3); SIPA § 78fff(b). In May 2010, pursuant to this provision, the bankruptcy court granted the Trustee's motion to stay two putative class actions filed in Florida by Madoff victims against fellow investor Jeffrey Picower, who allegedly profited from the scheme before its collapse. The Trustee had already sued Picower seeking the recovery of more than $5 billion and has indicated that he is on the verge of a settlement with Picower's estate. The bankruptcy court determined that, "[i]n order to assert such a claim independently of the administration of the bankruptcy case, a creditor must have suffered an injury 'significantly different' from the injuries to creditors in general."[43] According to the court, in this case, the plaintiffs did not contend that Picower owed them a separate duty or caused them a separate harm. Rather, plaintiffs sought redress in a way that would derivatively injure all other customer claimants in the liquidation. Thus, the plaintiffs were deemed to have violated the automatic stay by independently asserting claims that belonged to the SIPA estate.

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43. May 3, 2010 Memorandum Order and Decision Granting Trustee's Motion Pursuant to Bankruptcy Code Sections 362(a) and 105(a) and Bankruptcy Rule 7065 for Enforcement of the Automatic Stay and for a Preliminary Injunction

Shortly after this ruling by the bankruptcy court, the two Florida plaintiffs appealed. Among the issues that the plaintiffs designated to be presented on appeal was "[w]hether the Bankruptcy Court erred by not determining that the trustee … was barred by the doctrine of *in pari delicto* from pursuing the claims asserted by the Appellants in their complaints in Florida federal court against non-debtor third parties."[44] The court, however, granted the Trustee's motion to strike that issue and all related documents, finding that the doctrine of in pari delicto to be irrelevant to the court's imposition of the stay. The court noted that "a trustee acquires prepetition claims as property of the estate under Bankruptcy code § 541(a)(1) subject to whatever infirmities (such as an *in pari delicto* defense) that may have existed." Thus, the court found that the *in pari delicto* doctrine and the Trustee's standing "would become relevant only if the Trustee were to actually attempt to assert the claims himself, and only in the confines of that action."

5. *Cases Brought by Investors Against the SEC*

Several lawsuits have been filed by Madoff victims against the U.S. and/or the SEC under the the Federal Tort Claims Act ("FTCA"), including *Dichter-Mad Family Partners, LLP v. U.S.A.*, 2:09-cv-09061 (SVW) (C.D. Cal. filed Dec. 10, 2009); *Molchatsky v. U.S.A.*, 1:09-cv-08697 (LTS) (S.D.N.Y. filed Oct. 14, 2009); and *Slade Foundation v. U.S.A.*, 2:10-cv-02483 (LTS) (S.D.N.Y. filed March 23, 2010). The FTCA provides a limited waiver of the federal government's sovereign immunity when its employees are negligent while acting within the scope of their employment. The theory behind these lawsuits is that the SEC acknowledged missteps in its handling of its Madoff investigations, and that the investors' injuries resulted from the SEC's negligence. For example, in *Dichter-Mad Family Partners*, several Madoff victims brought an FTCA action against the U.S. and the SEC, alleging that the SEC "owes a duty of reasonable care to all members of the general public including all investors in U.S. financial markets who are foreseeably endangered by its

44. August 3, 2010 Memorandum Decision and Order Granting Trustee's Motion to Strike

conduct.” Plaintiffs also alleged that they relied on the SEC’s “implied stamp of approval” in making their investments in Madoff. In *Molchatsky*, two individual Madoff victims filed an FTCA complaint against the U.S. alleging money damages “arising from the serial, gross negligence of the United States Securities and Exchange Commission in performing its non-discretionary functions during its multiple investigations and examinations [of Madoff and BLMIS], triggered primarily by its receipt of numerous detailed, credible complaints between 1992 and 2008.” The third case, *Slade Foundation*, was filed by the same law firm as *Molchatsky* and was designated as a “related case” to *Molchatsky*.

In *Dichter-Mad Family Partners*, defendants moved to dismiss for lack of jurisdiction pursuant to the “discretional function exception” to the FTCA, under which federal courts are barred from adjudicating tort actions arising out of federal officers’ discretionary acts. In April 2010, the Central District of California court in *Dichter-Mad Family Partners* granted defendants’ motion to dismiss, giving plaintiffs leave to amend. It first dismissed the claims against the SEC, holding that the SEC was not a proper defendant, because the FTCA allows claims against the U.S. only, not its agencies. Further, the court dismissed the claims against the U.S., holding that—while plaintiffs’ allegations identified decisions that should have been made differently and, at times, showed the SEC’s incompetence—the complaint did not contain “any plausible allegation revealing that the SEC violated its clear, non-discretionary duties, or otherwise undertook a course of action that is not potentially susceptible to policy anaysis.”

The *Dichter-Mad Family Partners* plaintiffs subsequently filed an amended complaint, and a second motion to dismiss is being briefed. A motion to dismiss based on the discretional function exception is also in the process of being briefed in the *Molchatsky* case.

6. *Private Feeder Fund and Fund Auditor Litigation*

Finally, the last major category of litigation arising from the Madoff fraud—and the category with the most significant implications for auditor liability—is the hundreds of private lawsuits brought by investors against investment managers, hedge funds, banks and other parties who are alleged to have negligently, recklessly or knowingly brought about plaintiffs' losses by causing their money to be invested in BLMIS. These lawsuits were filed, and many are still pending, in state and federal courts across the country—including in New York, Florida, Texas, California, Pennsylvania, Connecticut and Massachusetts—and even internationally—in Luxembourg, for example.

a. Fund Auditors

In many of these private lawsuits, fund auditors have been named as defendants. The long list of auditors sued as part of the Madoff feeder fund litigation includes: BDO Seidman, LLP; BDO Tortuga; Citrin Cooperman & Company, LLP; Ernst & Young (Bahamas); Ernst & Young (Cayman Islands); Ernst & Young Global Limited; Ernst & Young LLP; Ernst & Young S.A.; Friedberg Smith & Co. P.C.; Fulvio & Associates, L.L.P.; KPMG (Cayman); KPMG International Cooperative; KPMG LLP; McGladrey & Pullen, LLP; PricewaterhouseCoopers Accounts Netherlands N.V.; PricewaterhouseCoopers LLP; PricewaterhouseCoopers Bermuda; PricewaterhouseCoopers International Ltd.; Rothstein, Kass & Company; and Rothstein, Kass & Company (Cayman).

The claims against fund auditors include federal statutory law claims (most commonly, Section 10(b) of the Securities Exchange Act of 1934); state statutory law claims (for example, state deceptive and unfair trade practices laws); and common law claims (including claims of fraud, breach of fiduciary duty, aiding and abetting breaches of fiduciary duty, negligence/gross negligence, negligent misrepresentation, unjust enrichment and malpractice). On motions to dismiss, auditors have made the following arguments:

- <u>Securities Litigation Uniform Standards Act ("SLUSA") preemption</u>: Congress enacted SLUSA to prevent class action plaintiffs from circumventing the requirements of the Private Securities Litigation Reform Act by pleading securities-related class action claims under state law. Under SLUSA, all state law claims brought on behalf of 50 or more persons alleging a material misrepresentation or omission, or a manipulative or deceptive device, in connection with the purchase or sale of a "covered security," based on the statutory or common law of any state, however labeled, are preempted and must be dismissed. Auditors in the Madoff litigations have argued that state law claims are preempted under SLUSA because they purport to bring a "covered class action," predicated on Madoff's fraudulent scheme, in connection with "covered securities" and based on common law.

- Martin Act preemption: The Martin Act is a New York statute that confers on the New York Attorney General the authority to investigate deceptive conduct in connection with the purchase or sale of securities within or from the state of New York. Most of the courts that have considered the issue have held that the statute vests the Attorney General with the sole authority to prosecute state law claims based on such conduct that do not require pleading or proof of intent. Accordingly, those courts have dismissed such claims brought by private litigants as preempted by the Martin Act. Auditors in the Madoff-related actions filed in New York have argued that non-fraud common law claims are preempted by the Martin Act.

- Failure to sufficiently plead elements of claims (scienter, reliance, loss causation, etc.)

    - Scienter: With respect to Section 10(b) and common law fraud claims, auditors have argued that mere allegations that they "would have discovered" Madoff's fraud had they conducted different audits are insufficient to plead actual intent to deceive, manipulate or defraud.

    - Reliance: With respect to Section 10(b), common law fraud and negligent misrepresentation claims, auditors have argued that plaintiffs have failed to allege that they actually read and relied on audited financial statements in making their investment decisions.

    - Loss causation/No proximate cause: With respect to Section 10(b), common law fraud, breach of fiduciary duty, aiding and abetting and negligent misrepresentation/malpractice claims, auditors have argued that plaintiffs' losses were unforeseeable and came about because Madoff stole from the partnerships that invested in him and used the stolen funds for his Ponzi scheme. Thus, plaintiffs' losses were not proximately caused by the auditors' conduct.

  - Lack of fiduciary relationship: With respect to breach of fiduciary duty claims, auditors have argued that, based on well settled law, auditors are not fiduciaries.
  - Lack of privity: With respect to negligence and negligent misrepresentation claims, auditors have argued that fund investors are not in privity or near privity with the fund auditors.
  - Lack of actual knowledge: With respect to aiding and abetting claims, auditors have argued that plaintiffs did not sufficiently allege that they had actual, rather than constructive, knowledge of the breach of duty.

- Other arguments: Some auditors have sought to arbitrate claims brought against them based on arbitration clauses in their engagement agreements, and some have raised statute of limitations defenses, arguing that the claims against them are untimely based on the dates of their audit opinions.

In some cases, fund investors have brought derivative actions on behalf of the funds against the funds' auditors. These derivative actions present unique issues for auditor defendants. For purposes of a derivative action, the investors in the funds step into the shoes of the fund in bringing suit against the fund's auditors; thus, the lack of privity arguments that auditor defendants can make in non-derivative cases are not applicable to derivative actions. However, the derivative actions may be subject to standing defenses, including under the doctrine of *in pari delicto*.

In pari delicto, a Latin phrase meaning "in equal fault," would prevent a plaintiff from bringing suit on behalf of a corporate entity against the entity's auditor, if the entity, by imputation, was also liable for the actions of its officers. Thus far, the *in pari delicto* defense has been rejected by a New York Supreme Court in one Madoff-related case, *Sacher v. Beacon Assoc. Mgmt. Corp.*, No. 005424/09, 2010 WL 1881951 (N.Y. Sup., Nassau Co., Apr. 26, 2010) (summarized below), and the same issue is pending in another Madoff-related case.

A noteworthy, recent development is the certification of *in pari delicto* issues to the New York Court of Appeals in two separate cases unrelated to the Madoff scheme. First, the Delaware Supreme Court—hearing an appeal of a Chancery Court dismissal of claims against an auditor based on the *in pari delicto* doctrine—certified the following question to the New York Court of Appeals: "Would the doctrine of *in pari delicto* bar a derivative claim under New York laws where a corporation sues its outside auditor for professional malpractice or negligence based on the auditor's failure to detect fraud committed by the corporation; and, the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in its audits of the corporation's financial statements?"[45] The Court of Appeals has accepted the question but has not yet issued a decision. Further, the Second Circuit—hearing an appeal arising out of the Refco bankruptcy proceeding, where the issue was whether the acts of corporate insiders can be imputed to the corporation, such that the bankruptcy trustee for the corporation would lack standing to recover against an auditor of the corporation for damage to creditors—certified a series of questions to the New York Court of Appeals concerning the principles of imputation and the "adverse exception" to imputation.[46] In both cases, the New York Court of Appeals has accepted the certified questions but has not yet issued a decision on them.

b. Court Rulings

In a number of the Madoff-related private lawsuits, courts have made significant contributions to the decisional law regarding auditor liability in Ponzi scheme litigation.

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45. *Teachers Ret. Sys. of Louisiana v. PricewaterhouseCoopers LLP*, No. 454, 2009, — A.2d —, 2010 WL 728794 (Del. March 3, 2010)
46. *Kirscher v. KPMG LLP*, 590 F.3d 186 (2d Cir. 2009)

- ***Backus v. Conn. Cmty. Bank, N.A.*, No. 09 Cv. 1256, 2009 WL 5184360 (D. Conn. Dec. 23, 2009):** Plaintiffs, who originally filed the case in state court but faced removal to federal court, alleged that they had pooled their retirement funds in a bank pursuant to custodian agreements for the purpose of investing with Madoff. After they lost their money, plaintiffs brought suit against the bank for breach of contract, theft, fraud and violations of the Connecticut Unfair Trade Practices Act. On December 23, 2009, the court granted defendants' motion to dismiss all of the claims on SLUSA preemption grounds. The court stated that "[t]he most difficult question before the Court is whether the remaining claims are 'in connection with the purchase or sale of a covered security.'" However, it found that, while plaintiffs did not allege that the defendant knew of Madoff's Ponzi scheme, they did allege that defendant intentionally misreported its own securities holdings. The court went on to find that "[g]iven the nature of the allegations in the Complaint, the relationship between the parties, and the broad application of SLUSA espoused by the Supreme Court in *Dabit*, the Court finds that all counts against Defendant are 'in connection with the purchase or sale of a covered security.'" With respect to the breach of contract claim, the court held that it was "an integral part of [the alleged fraudulent] scheme and therefore [could not] escape SLUSA preemption."
- ***Levinson v. PSCC Servs. Inc.*, No. 09 Cv. 269, 2009 WL 5184363 (D. Conn. Dec. 23, 2009):** Similar to *Backus*, plaintiffs pooled their retirement funds in a bank pursuant to custodian agreements. After losing their money to Madoff, plaintiffs brought RICO and various state law claims against the bank. The court granted defendants' motions to dismiss. With respect to the RICO claims, the court held that they were barred by Section 107 of the Private Securities Litigation Reform Act, which disallows RICO claims that are based on conduct that would have been actionable as securities fraud. The court further held that all the state law claims were preempted by SLUSA.

- ***Cocchi v. Tremont Group Holdings, Inc.*, No. 502009 CA 016230 (Palm Beach Co. Feb. 5, 2010):** This case was brought by investors in Tremont-managed funds. KPMG LLP was among the defendants, charged with negligent misrepresentation, professional malpractice, aiding and abetting breaches of fiduciary duty, and violation of Florida's Unfair and Deceptive Trade Practices Act ("FUDTPA"). On February 5, 2010, the court granted in part and denied in part defendants' motions to dismiss. With respect to the claims against KPMG, the common law claims were dismissed on several grounds, including that the claims were derivative, rather than direct, and thus plaintiffs did not sufficiently allege standing. However, the FUDTPA claim against KPMG survived the motion to dismiss, with the court finding that it was premature to decide whether Florida or New York law applied and whether the investments at issue are "securities" outside the scope of the FUDTPA.
- ***Barron v. Igolnikov*, No. 09 Civ. 4471, 2010 WL 882890 (S.D.N.Y. March 10, 2010):** Plaintiffs were investors in several Union Bancaire Privee funds, which invested indirectly in Madoff by allocating a portion of their assets to four Madoff feeder funds. Plaintiffs asserted four state law claims: breach of fiduciary duty; aiding and abetting breach of fiduciary duty; gross negligence; and unjust enrichment. No auditors were named as defendants. Defendants moved to dismiss for lack of subject matter jurisdiction and failure to state a claim on the grounds that the action was preempted by SLUSA and the Martin Act; plaintiff lacked standing to sue on behalf of investors in the funds in which she did not invest; and plaintiff's claims were barred by the exculpation provision in her limited partnership agreement. On March 10, 2010, the court granted the motion to dismiss on SLUSA preemption grounds. It held that "[i]n light of the Supreme Court's command that SLUSA be construed expansively, it is enough that this fraudulent scheme was in connection with the trading in the nationally listed securities in which Madoff claimed to be engaged. It is not essential that

Madoff actually performed any trades or acquired any securities. And while plaintiff and members of the putative class purchased limited partnership interests in the UBP Funds – which in turn invested in covered securities – rather than covered securities directly from Madoff, SLUSA preemption is justified because the securities transaction need not have been performed by plaintiff. Rather, it is only necessary to demonstrate deception in connection with the purchase or sale of a covered security, not the deception of plaintiff herself." Separately, the court held that the claims were also preempted by the Martin Act, finding that "Plaintiff's claims plainly [fell] within the scope of the Martin Act."

The district court's decision in *Barron* is being appealed to the Second Circuit Court of Appeals, with the plaintiffs arguing that neither the Martin Act nor SLUSA preemption applies.[47] As to SLUSA, plaintiffs contend that the statute's preemptive force does not apply in this case because the complaint does not assert any federal securities claims and does not depend upon any misrepresentation claims, but, rather, is limited to state law claims based on the defendants' mismanagement and breach of fiduciary duties. Further, they argue that the limited partnership interests in which plaintiffs invested are not covered securities for SLUSA purposes. As to the Martin Act, plaintiffs relied in large part on a post-*Barron* holding from another S.D.N.Y. district court in a Madoff-related action, *Anwar v. Fairfield Greenwich Limited* (described below), in which the court rejected defendants' Martin Act preemption arguments.

The New York Attorney General filed an amicus brief in the appeal, weighing in on the issue of Martin Act preemption.[48] The Attorney General argued that the decisions holding that the Martin Act preempted private claims "reflect a mistaken understanding of the Martin Act," which "neither increased nor diminished the

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47. *Barron v. Igolnikov*, No. 10-1387-cv (2d Cir. 2010)
48. Brief for the Attorney General of the State of New York as Amicus Curiae

remedies available to private litigants." Specifically, according to the amicus brief, a finding of preemption is not supported by either the text or history of the Martin Act, nor is it warranted based on policy considerations. The brief states, "Private common-law actions for the most part advance, and do not hinder, the Attorney General's fundamental mission under the Martin Act to eliminate fraudulent practices in the sale or purchase of securities across this State, because the Attorney General cannot possibly take sole responsibility for policing the marketplace in securities fraud."

- ***Hecht v. Andover Assoc. Mgmt. Corp.*, No. 006110/09, 2010 WL 1254546 (Sup. Ct. N.Y. Co. March 12, 2010):** Investors brought a derivative suit on behalf of Andover Associates, an investment company that used Madoff as its investment adviser, against the company's officers, outside consultant and auditor (Citrin Cooperman & Co., LLP). The claim against Citrin Cooperman was for accountants' negligence. On March 12, 2010, the court largely denied defendants' motion to dismiss. Most saliently for the auditor defendant, the court held that "[g]iving plaintiff the benefit of every possible favorable inference, the court must assume that an audit of Andover Associates' investments conducted pursuant to generally accepted accounting procedures [sic] would have uncovered Madoff's fraud." Further, in response to Citrin Cooperman's argument that plaintiff could show no damages because plaintiff made his investment in 2002 and Citrin did not become the auditors until 2006, after the plaintiffs' investment was lost, the court held that it "must assume that a proper audit would have provided Andover with the opportunity to liquidate its investment."
- ***In re Tremont Securities Law, State Law and Insurance Litigation (Securities Action)*, No. 08 Civ. 11212 (TPG), 2010 WL 1257580 (S.D.N.Y. March 30, 2010):** This consolidated group of cases was brought by investors in funds managed by Tremont Partners, which served as feeder funds to Madoff, alleging both federal securities laws and common law violations. Defendants

included various Tremont-related parties as well as two auditors, KPMG LLP and Ernst & Young LLP. As to the auditors, the Consolidated Amended Complaint asserted violations of the Exchange Act; common law fraud; breach of fiduciary duty; aiding and abetting breaches of fiduciary duty; and negligent misrepresentation. The plaintiffs' theory was that the fund's auditors "failed to detect the massive fraud perpetrated by Madoff during the course of their audits" and also "neglected to notify investors of the risks associated with investing in the funds." The auditor defendants moved to dismiss on various grounds. On March 30, 2010, the court granted Ernst & Young's and KPMG's motions to dismiss. The court first dismissed the Section 10(b) claim under the Exchange Act for failure to plead a strong inference of scienter. The court stated that "alleging a shoddy audit in violation of GAAS does not establish the intent to defraud" and, further, that plaintiffs did not "allege that the Auditors were aware of any facts indicative of Madoff's fraud that they consciously disregarded." "Most critically," the court held, "the Auditors were never engaged to audit Madoff's business or to issue an opinion on the financial statements of BMIS." The court found that "[t]he notion that a firm hired to audit the financial statements of one client … must conduct audit procedures on a third party that is not an audit client (BMIS) on whose financial statements the audit firm expresses no opinion has no basis." The court further held that the elements of common law fraud in New York are essentially the same as for Section 10(b) and thus, it dismissed plaintiffs' fraud claim as well. As to the rest of plaintiff's common law claims against Ernst & Young and KPMG, the court held that they were preempted by the Martin Act, finding that the non-fraud common law claims "plainly [fell] within the ambit of the Martin Act." In one set of the consolidated *In re Tremont* group of cases, in which derivative claims were asserted, the court granted KPMG's motion to dismiss, finding that the claims against it were subject to mandatory arbitration.

- ***Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, No. 09 Civ. 3708 (TPG), 2010 WL 1257567 (S.D.N.Y. March 31, 2010):** Plaintiffs were hedge funds that invested substantially all of their assets in Madoff feeder funds managed by Tremont Partners. KPMG LLP and KPMG (Cayman) were among the defendants, charged with Section 10(b) violations, common law fraud and negligence. (In separate actions, the *Meridian* plaintiffs have been named as defendants in lawsuits brought by investors.) On March 31, 2010, the court granted the KPMG defendants' motions to dismiss on essentially the same grounds as in the Tremont action, finding insufficient allegations of scienter for the Section 10(b) and common law fraud claims, and Martin Act preemption for the non-fraud common law claims.

- ***Stephenson v. Citco Group Ltd.*, No. 09 CV 00716 (RJH), 2010 WL 1244007 (S.D.N.Y. Apr. 1, 2010):** Plaintiff was the trustee of a trust that invested in a feeder fund, which in turn invested in BLMIS. The feeder fund was not a defendant to this action. The defendants included the fund's administrator, sub-administrator, and independent auditor (PricewaterhouseCoopers, LLP). The complaint asserted seven state law claims. On April 1, 2010, the court dismissed the complaint in its entirety. It held that the claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and breach of contract were all derivative claims that could not be brought directly, because plaintiff "could not demonstrate his own injury without demonstrating that the partnership was injured." It separately held that the fiduciary duty claims were preempted by the Martin Act, as were the negligence and gross negligence claims. Finally, the court found that plaintiff did not adequately plead scienter required for the fraud claim. Plaintiff was granted leave to replead only the fraud claim against PricewaterhouseCoopers.

- ***Sacher v. Beacon Assoc. Mgmt. Corp.*, No. 005424/09, 2010 WL 1881951 (N.Y. Sup., Nassau Co., Apr. 26, 2010):** Members of Beacon Associates brought this derivative lawsuit, alleging that all of the company's assets were invested with Madoff. Among the defendants was the company's auditor, Friedberg, Smith & Co. P.C. On April 26, 2010, the court denied defendants' motion to dismiss the action and granted their motion to stay pending resolution of an identical federal action. As to the accounting malpractice claim, the court found that "[o]n this motion to dismiss, the court must assume that Madoff's criminal conduct was a 'normal' and foreseeable consequence of defendant's failure to conduct a proper audit," and thus proximate cause was held to be sufficiently alleged. The court further rejected the auditor's *in pari delicto* defense, finding that the knowledge of Beacon Associates' management could not be imputed to the company by application of "an exception to the rule of imputed knowledge when the agent is engaged in a scheme to defraud the principal. The agent cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose." Further, the court rejected the auditor's statute of limitations argument.

- ***CRT Investments, Ltd. v. Merkin*, No. 601052/09 (Sup. Ct., N.Y. Co. May 5, 2010):** This case was brought by investors in the Ascot Fund, which was managed by defendant Ezra Merkin and invested all its assets in Madoff. Fund auditors BDO Seidman and BDO Tortuga were among the defendants. On May 5, 2010, the court granted defendants' motions to dismiss as to all claims against BDO Seidman and some claims against Merkin. Relying liberally on the *In re Tremont* and *Meridian* opinions in the Southern District of New York, the New York Supreme Court in this case held that the common law non-fraud claims were preempted by the Martin Act and that the common law fraud/aiding and abetting fraud claims against the auditors were dismissed for lack of scienter. Alternatively, the court dismissed the negligent misrepresentation claim against BDO Seidman on lack of privity grounds, finding that plaintiffs failed to allege "linking conduct" between the fund auditor and themselves as non-client investors in the audited funds. The court also held that it lacked personal jurisdiction over BDO Tortuga. The fraud claim against Merkin survived the motion to dismiss.

- ***MLSMK Inv. Co. v. JP Morgan Chase & Co.*, 1:09-cv-04049 (S.D.N.Y. July 15, 2010):** Plaintiff alleged that the defendant, a financial services firm, maintained an account for Madoff in which all of his investment advisory business money was deposited. Plaintiff further alleged that the defendant grew suspicious of Madoff, conducted an investigation, and concluded that he was fraudulent, at which time the defendant "decided to 'partner with [Madoff] in the fleecing of his victims." No auditors were named in the lawsuit. On July 15, 2010, the court dismissed the plaintiff's claims. It found that the complaint contained insufficient allegations of motive, conscious misbehavior, or recklessness and thus, failed to give rise to a strong inference of fraudulent intent as required for its fraud claim. Further, the court found that the plaintiff's conclusory allegations of actual knowledge were insufficient to plead aiding and abetting a breach of fiduciary duty. Finally, as to plaintiff's negligence claim, the court found that plaintiff failed to allege that the bank owed a duty of care to plaintiff.

- ***Anwar v. Fairfield Greenwich Limited*, No. 09 Civ. 0118 (VM) (S.D.N.Y. July 29, 2010):** Investors in four Fairfield-managed funds sued the Fairfield companies, directors, auditors and other related entities. On July 29, 2010, the court issued a ruling holding that, contrary to the defendants' argument, plaintiffs' common law claims were not preempted by the Martin Act. In so doing, the court acknowledged that it was diverging from the holdings of the majority of the district courts in the Southern District of New York and numerous New York state courts. The court noted that, while the New York Court of Appeals held that the Martin Act did not authorize private causes of action, it did not decide whether common law claims based on the same facts were preempted by the Martin Act. The court went on to opine that "while a significant body of judicial opinion finding a preemptive reading of the Martin Act exists, better reasoned and more persuasive authorities reject that view." Significant to the court's decision were the legislative history and intent behind the Act, the fact that the Attorney General flatly rejected a preempted reading of the Act, and a finding that preemption clashes with the Martin Act's goals to prevent fraud in connection with securities sales and to defeat fraudulent schemes.

In August 2010, the court issued another ruling on the remaining arguments in the defendants' motions to dismiss. As to the auditor defendants (PricewaterhouseCoopers LLC, PricewaterhouseCoopers Accountants Netherlands N.V., and PricewaterhouseCoopers International Ltd.), the court dismissed the securities fraud claims, finding that plaintiffs failed to adequately allege scienter. The court rejected the argument that the plaintiffs' state law claims were preempted by SLUSA, holding that the securities the plaintiffs purchased here (interests in various funds) were not covered securities and that the chain from the plaintiffs' investments to Madoff's purported purchases of securities was too attenuated. Nevertheless, the court dismissed the claims against the auditors for gross negligence; third party beneficiary; unjust enrichment; and aiding and abetting breach of fiduciary duty, finding that plaintiffs had not adequately pleaded the elements of those claims. Further, the court dismissed the claims against PricewaterhouseCoopers International Ltd. that were based on control person and vicarious liability theories. One claim against the auditor defendants survived the motions to dismiss: a negligent misrepresentation claim. The court found that it was reasonable to infer that the auditors knew and intended for the investors to rely on their audit reports, and that addressing the reports to the investors was sufficient linking conduct for a negligent misrepresentation claim under New York law.

- ***In re Banco Santander Securities-Optimal Litig.*, 1:09-cv-20215 (S.D. Fl. July 30, 2010):** Foreign investors who purchased securities in Bahamian investment funds, which were closed to American investors, brought this lawsuit. On July 30, 2010, the court issued a ruling granting six of the defendants' motions to dismiss based on lack of personal jurisdiction. Among these six defendants were PricewaterhouseCoopers Bermuda and PricewaterhouseCoopers Ireland, as to which the court rejected plaintiffs' argument that there was an agency relationship imputing PricewaterhouseCoopers LLP's and PricewaterhouseCoopers Bermuda's conduct to PricewaterhouseCoopers Ireland for jurisdictional purposes. Further, the court stated that "since the Court lacks personal jurisdiction over half … of the Defendants … it makes little sense to try an expensive and time consuming case in Florida while another court, in a virtually duplicative proceeding over four thousand miles away, potentially adjudicates the same legal and factual questions." Thus, the court dismissed the case in its entirety under the doctrine of *forum non conveniens*, finding that the case should have been brought in Ireland. One of the two U.S. citizen defendants was PricewaterhouseCoopers LLP, based in New York, which the court called "at best, a minor player in this litigation."

- **Luxembourg Litigation:** In addition to the U.S. court rulings discussed above, on March 4, 2010, a Luxembourg court ruled that individual investors who lost money in Madoff's fraud lack standing to sue UBS AG and its auditor for losses in the bank's LuxAlpha funds, because they failed to show they suffered individual damage separate and apart from the funds themselves and failed to show any individual damage suffered by the alleged behavior of UBS or its auditor. The court held that the investors must instead rely on the fund liquidator to obtain compensation for them from UBS.