

# Client Alert

Latham & Watkins Litigation Department

## Second Circuit Dismisses Section 10(b) Claims Against Outside Auditors of Funds That Invested With Madoff

On July 10, 2012, the US Court of Appeals for the Second Circuit in *Meridian Horizon Fund, LP v. KPMG (Canyon)* affirmed the dismissal of claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5 against the outside auditors of hedge funds that invested in Bernard L. Madoff Investment Securities, LLC.<sup>1</sup> The court held that the putative class of hedge fund investors failed to allege sufficient facts that the auditors acted with the requisite scienter. Instead, the court found, the more compelling inference from the auditors' failure to discover Madoff's fraud was that Madoff was proficient at concealing his scheme. The court also affirmed the district court's dismissal of various state law claims. This ruling was one of two recent decisions by the Second Circuit regarding auditor liability under Section 10(b) and Rule 10b-5. In the other decision, *Gould v. Winstar Communications, Inc.*, the Second Circuit reversed the district court's summary judgment in favor of an outside auditor after finding that at least some evidence existed to support the assertion that the auditor learned of and acquiesced in its client's deceptive accounting schemes.<sup>2</sup>

### Factual Background

*Meridian Horizon Fund* consolidated appeals by two groups of investors in certain hedge funds which were managed by Tremont Group Holdings, Inc. (Tremont) and its affiliates, and which invested in Bernard L. Madoff Investment Securities, LLC (BLMIS). Plaintiffs alleged that the hedge funds' outside auditors violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 by misrepresenting that they conducted audits of the funds in accordance with Generally Accepted Auditing Standards (GAAS).

Specifically, plaintiffs alleged that the auditors ignored "red flags" that would have necessitated "heightened professional skepticism," such as the fact that the hedge funds relied on BLMIS for portfolio management, trade execution and custodial services.<sup>3</sup> Plaintiffs contended that due to these "red flags," GAAS required the auditors to obtain independent audit evidence to corroborate the existence of the assets that Madoff and BLMIS claimed to hold for the hedge funds. Had the auditors verified BLMIS' reported assets and trades, plaintiffs argued, the auditors would have uncovered Madoff's fraud by discovering that the audits performed

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by BLMIS's accounting firm were a sham. The auditors' failure to comply with the purported GAAS requirements thus amounted to a meaningless audit. Plaintiffs also claimed that the auditors committed common law fraud, acted negligently, breached their fiduciary duties to plaintiffs and aided and abetted Tremont's breach of fiduciary duty.

## **Section 10(b) of the Securities Exchange Act and Rule 10b-5**

Section 10(b) of the Securities Exchange Act makes it unlawful to use, in connection with the sale or purchase of securities, "any manipulative or deceptive device or contrivance" in contravention of rules and regulations prescribed by the SEC.<sup>4</sup> Rule 10b-5 provides that it is unlawful, in connection with the purchase or sale of any security, "to employ any device, scheme, or artifice to defraud, . . . to make any untrue statement of a material fact or omit to state a material fact . . . , [or] to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person."<sup>5</sup> To plead a claim under Section 10(b) or Rule 10b-5, a plaintiff must allege that (1) the defendant made misstatements or omissions of material fact, (2) with scienter, (3) upon which the plaintiff relied and (4) that the plaintiff's reliance was the cause of his injury.<sup>6</sup>

## **The District Court's Decision**

The district court explained that in order to state a claim under Rule 10b-5 against an auditor, a plaintiff must allege more than GAAS violations — a plaintiff must also allege the auditor's corresponding scienter or fraudulent intent. Moreover, in order to allege the adequate level of recklessness on behalf of a non-fiduciary accountant, a plaintiff must allege conduct that is "highly unreasonable, representing an extreme departure from the standards of ordinary care."<sup>7</sup> Such recklessness must "approximate an actual intent to aid in the fraud being perpetrated by the audited company."<sup>8</sup> Thus, a plaintiff must allege that the accounting practices were "so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."<sup>9</sup>

In this case, the district court found that plaintiffs merely had alleged a "shoddy audit" in violation of GAAS, which is not enough to establish the necessary intent to defraud.<sup>10</sup> As to the alleged "red flags," the court noted that the hedge funds in which the plaintiffs invested had plainly disclosed to investors that Madoff, the investment manager, would perform both brokerage and custodial duties. In addition, plaintiffs failed to allege that the defendant auditors were aware of any facts indicating Madoff's fraud. The court thus rejected plaintiffs' theory that the auditors could not have acted innocently when they stated in their audit opinions that they conducted audits in compliance with GAAS. The more compelling inference was that Madoff's fraud went undetected for two decades because Madoff was proficient in covering up his scheme and deceiving the SEC and other financial professionals. The auditors, the court found, were similarly in the dark.

Critically, the court noted, the auditors were not hired to audit BLMIS. Rather, they were hired to audit the hedge funds that plaintiffs invested in. As the court stated, "[t]he notion that a firm engaged to audit the financial statement of one client . . . must conduct audit procedures on a third party that is not an audit client . . . on whose financial statement the audit firm expresses no opinion is

unprecedented and has no basis.”<sup>11</sup>

The district court further determined that because the plaintiff investors failed to allege scienter adequately, the court did not need to consider the other elements of the plaintiffs’ claims under Section 10(b) or Rule 10b-5, including the auditors’ loss causation arguments.

Because the elements of common law fraud are “essentially the same” as those required to establish a claim under Section 10(b) and Rule 10b-5, the court dismissed plaintiffs’ common law fraud claims for failure to plead scienter.<sup>12</sup>

The court also dismissed plaintiffs’ negligence claims on the grounds that New York’s Martin Act vests the New York Attorney General with the sole authority to prosecute a state law securities claim based on conduct that is “within or from” New York, sounds in fraud or deception, and does not require proof of intent.<sup>13</sup> In addition, in an oral ruling, the court dismissed plaintiffs’ negligence and breach of fiduciary duty claims on the grounds, among others, that these claims were preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA).<sup>14</sup>

## **The Second Circuit's Decision**

The Second Circuit affirmed the district court’s dismissal of plaintiffs’ Section 10(b) and Rule 10b-5 claims on the grounds that plaintiffs failed to plead scienter adequately. The court described plaintiffs’ complaint as “an archetypal example of impermissible allegations of fraud by hindsight.”<sup>15</sup> The court emphasized that the defendant auditors were hired to audit the hedge funds, not BLMIS, and that the purported “red flags,” such as the lack of an independent third-party custodian and BLMIS’s dual role as an investment manager and administrator, were risks inherent to BLMIS — not the hedge funds. In addition, these “red flags” were disclosed not only to the plaintiff investors in the feeder funds’ offering materials, but also to the SEC and other investors in and auditors of other funds that invested with Madoff, none of whom discovered the fraud. This strengthened the inference that the reason the defendant auditors did not discover Madoff’s fraud was that Madoff was proficient at concealing his fraud.<sup>16</sup>

The Second Circuit also affirmed the district court’s dismissal of plaintiffs’ common law fraud claims for failure to plead scienter adequately. The court further upheld the district court’s dismissal of plaintiffs’ negligence claims, but for different reasons. The Second Circuit held that the Martin Act does not preempt the claims at issue.<sup>17</sup> Nonetheless, under New York law, a plaintiff alleging negligence against an accountant with whom he has no contractual relationship must show that the accountant was aware that “a known party or parties was intended to rely” on his reports, and that there was some conduct on behalf of the auditors “linking them to that party or parties, which evinces the accountants’ understanding of that party or parties’ reliance.”<sup>18</sup> The court held that plaintiffs had failed to satisfy both of these requirements.

In addition, the court held that plaintiffs’ fiduciary duty claims were properly dismissed. First, plaintiffs failed to allege properly that the auditors owed a fiduciary duty to Tremont’s investors. Plaintiffs also failed to allege properly that the auditors aided and abetted Tremont’s breach of fiduciary duty because plaintiffs failed to provide any facts supporting the auditors’ participation, with the requisite scienter, in Tremont’s alleged breach of fiduciary duty.

## Conclusion

The Southern District of New York and Second Circuit decisions reaffirm the principle that a plaintiff cannot plead a violation of Section 10(b) and Rule 10b-5 by an outside auditor simply by relying on a massive underlying fraud — even a fraud of Madoff's proportions. This is particularly true, notwithstanding the allegation of generic "red flags," when that fraud is perpetrated not by the auditor's client but by a third party. In contrast, as demonstrated in the other recent Second Circuit auditor decision referenced above, *Gould v. Winstar Communications, Inc.*, a plaintiff may state a successful claim by alleging that an auditor uncovered but then acquiesced in a deceptive accounting scheme perpetrated by its own client.<sup>19</sup>

### Endnotes

<sup>1</sup> *Meridian Horizon Fund, L.P. v. KPMG (Cayman)*, Nos. 11-3311-cv, 11-3725-cv, 2012 WL 2754933, at \*3 (2d Cir. July 10, 2012).

<sup>2</sup> *Gould v. Winstar Communications, Inc.*, Nos. 10-40280-cv, 10-4280-cv, 2012 WL 2924254, at \*8 (2d Cir. July 19, 2012).

<sup>3</sup> *Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, 747 F. Supp. 2d 406, 413 (S.D.N.Y. 2010). While this *Client Alert* cites to and quotes from only one of the district court opinions affirmed by the Second Circuit, *id.*, the facts, allegations and holding of the other district court opinion addressed by the Second Circuit's opinion, *In re Tremont Sec. Law, State Law & Ins. Litig.*, 703 F. Supp. 2d 362 (S.D.N.Y. 2010), are nearly identical.

<sup>4</sup> 15 U.S.C. § 78j(b).

<sup>5</sup> 17 C.F.R. § 240.10b-5.

<sup>6</sup> *Meridian Horizon Fund*, 747 F. Supp. 2d at 412.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 413.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 414.

<sup>13</sup> *Id.* (citing N.Y. Gen. Bus. Law. § 342-c(1)).

<sup>14</sup> *Meridian Horizon Fund*, 2012 WL 2754933, at \*3.

<sup>15</sup> *Id.*

<sup>16</sup> One defendant contended that dismissal was also proper under the Supreme Court's holding in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2884 (2010), because certain offshore plaintiffs' claims arose from wholly foreign transactions, and Section 10(b) does not have extraterritorial effect. The Second Circuit declined to address this issue, however, because of its holding on scienter.

<sup>17</sup> In *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 18 N.Y.3d 341 (2011), the New York Court of Appeals held that the Martin Act does not preempt a common law claim unless the claim is entirely dependent on the Martin Act for its viability. 18 N.Y.3d at 353.

<sup>18</sup> *Meridian Horizon Fund*, 2012 WL 2754933, at \*4.

<sup>19</sup> *Gould*, 2012 WL 2924254, at \*8.

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