

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-----X
KING COUNTY, WASHINGTON, :
IOWA STUDENT LOAN LIQUIDITY :
CORPORATION, Together and on :
Behalf of All Others Similarly Situated, :

Plaintiffs, :

- against - :

IKB DEUTSCHE INDUSTRIEBANK :
AG, et al., :

Defendants. :
-----X

09 Civ. No. 8387 (SAS)

ECF Case

ABU DHABI COMMERCIAL BANK, et al., :

Plaintiffs, :

- against - :

MORGAN STANLEY & CO. INC, et al., :

Defendants :
-----X

08-cv-7508 (SAS)

ECF Case

**MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS MORGAN STANLEY &
CO. INCORPORATED AND MORGAN STANLEY & CO. INTERNATIONAL
LIMITED'S MOTION FOR RECONSIDERATION**

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Defendants Morgan Stanley & Co. Inc. (n/k/a Morgan Stanley & Co. LLC) and Morgan Stanley & Co. International Limited (n/k/a Morgan Stanley & Co. International plc) (together, “Morgan Stanley”) respectfully submit this memorandum of law in support of their motion, pursuant to Local Rule 6.3, seeking partial reconsideration of this Court’s May 4, 2012 orders in the above-captioned matters (the “Orders”) which granted in part and denied in part defendants’ motions to dismiss. *See King County, Washington v. IKB Deutsche Industriebank AG*, 2012 WL 1592193, at *9 (S.D.N.Y. May 4, 2012); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 08 Civ. 7508 (SAS) (Dkt. No. 404).¹ The Second Circuit’s recent decision in *Stephenson v. PricewaterhouseCoopers, LLP*, 2012 WL 1764191, on May 18, 2012 contradicts this Court’s holding that plaintiffs sufficiently alleged that Morgan Stanley had a special, privity-like relationship with them.² As the Second Circuit explained in *Stephenson*, a complaint must allege that the defendant “knew the identity of the specific non-privity [sic] party who would be relying” on the alleged misstatement. *Id.* at *3 (emphasis added). Plaintiffs did not, and cannot, allege that Morgan Stanley knew the identity of either plaintiff in the *King County* action or a number of plaintiffs in the *ADCB* action. In light of the Second Circuit’s recent decision, reconsideration of the Court’s denials of Morgan Stanley’s motions to dismiss plaintiffs’ negligent misrepresentation claims is warranted.

¹ Morgan Stanley filed motions for partial reconsideration of the Orders based on the Second Circuit’s recent decision in *City of Omaha, Nebraska Civilian Employees’ Retirement System v. CBS Corp.*, 2012 WL 1624022 (May 10, 2012). *See King County*, Dkt. No. 248; *ADCB*, Dkt. No. 410. While each of plaintiffs’ negligent misrepresentation claims fails against Morgan Stanley for the reasons set forth therein, Morgan Stanley respectfully files this motion regarding additional grounds for dismissal as to each plaintiff in the *King County* action and as to plaintiffs King County, Washington (“King County”), The Bank of N.T. Butterfield & Son Limited (“Butterfield”), and SEI Investment Strategies, LLC (“SEI Strategies”) in the *ADCB* action.

² While the *Stephenson* decision is a summary order and thus does not have a binding precedential effect, it serves to clarify the applicable controlling law.

STANDARD

Motions for reconsideration are governed by Local Rule 6.3 and are committed to the sound discretion of the district court. “A motion for reconsideration is appropriate where ‘the moving party can point to controlling decisions or data that the court overlooked – matters, in other words, that might reasonably be expected to alter the conclusion reached by the court.’” *Medisim Ltd. v. BestMed LLC*, No. 10 Civ. 2463 (SAS), 2012 WL 1450420, at *1 (S.D.N.Y. Apr. 23, 2012) (Scheindlin, J.).³ “Typical grounds for reconsideration include an intervening change of controlling law, the availability of new evidence, or the need to correct a clear error or prevent manifest injustice.” *See, e.g., Gucci Am., Inc. v. Guess?, Inc.*, No. 09 Civ. 4373 (SAS), 2011 WL 6326032, at *1 (S.D.N.Y. Dec. 16, 2011) (Scheindlin, J.). Reconsideration is appropriate here because two weeks after the Court issued its Orders, the Second Circuit clarified the law with respect to the imposition of a legal duty under New York’s *Credit Alliance* test.

ARGUMENT

Under New York law, in the absence of actual contractual privity, plaintiffs must allege a special relationship sufficient to give rise to a legal duty. *See Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985). Whether a special relationship exists is governed by a three factor test set forth in *Credit Alliance*. *Id.*; *see also King County*, 2012 WL 1592193, at *10. The Second Circuit’s recent decision in *Stephenson* makes clear that the “known party” prong of the *Credit Alliance* test requires that the defendant “knew the identity of the specific non-privity [sic] party who would be relying.” *Stephenson*, 2012 WL 1764191, at *3 (emphasis added).

³ Because the Second Circuit’s opinion was not issued until two weeks after the Court’s decision, Morgan Stanley respectfully requests that the Court waive the 14-day filing requirement in its discretion under Local Rule 6.3. Alternatively, Morgan Stanley requests leave to file a renewed motion to dismiss in the light of the *Stephenson* decision.

With respect to the *ADCB* action, while plaintiffs allege that Morgan Stanley “had direct communications with and knew the specific identities of” certain plaintiffs, there is no allegation that Morgan Stanley knew the identity of King County, Butterfield, or SEI Strategies. *See ADCB Ninth Amended Complaint* ¶ 216(l).⁴ In *King County*, plaintiffs do not, and cannot, allege that Morgan Stanley knew the specific identity of either King County or Iowa Student Loan Liquidity Corporation (“ISL”). Indeed, the allegations conspicuously stop short of alleging that Morgan Stanley knew the identities of either plaintiff in the *King County* action and instead allege that Morgan Stanley knew the identities of “the Senior Notes investors” generally. This generic allegation is insufficient to satisfy even the basic pleading requirements of Federal Rule of Civil Procedure 8(a), much less the more rigorous requirements of Rule 9(b).⁵ Plaintiffs do not allege that Morgan Stanley knew the identities of either King County or ISL specifically or that Morgan Stanley knew the identities of every Senior Note Investor. Moreover, as explained in *Stephenson*, allegations that Morgan Stanley could or should have known their identities are insufficient under *Sykes* and *Credit Alliance*. Plaintiffs have thus failed to allege that Morgan Stanley owed them any legal duty for the additional reason that they have failed to satisfy the pleading requirements under the “known party” prong of the *Credit Alliance* test and their claims should be dismissed.

This Court relied on *LaSalle National Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071, 1092-93 (S.D.N.Y. 1996) in reaching its conclusion that “[k]nowledge of the identity of each particular plaintiff is not necessary.” *King County*, 2012 WL 1592193, at *12 &

⁴ Morgan Stanley does not concede that it “knew the specific identities of” the other *ADCB* plaintiffs as alleged in paragraph 216(l) of the Ninth Amended Complaint.

⁵ Because “[n]egligent misrepresentation is a type of fraud,” it is subject to the heightened pleading requirement of Federal Rule of Civil Procedure 9(b). *See, e.g., King County*, 2012 WL 1592193, at *12 & n.177

n.168. The Second Circuit, however, disregarded *LaSalle* and reached the contrary conclusion in *Stephenson*. In *Stephenson*, as here, the plaintiff argued that he was a “known party” because he was part of a “small and defined class of prospective investors” and cited *LaSalle* and *White v. Guarente*, 43 N.Y.2d 356, 363 (1977) for support. See *Stephenson* Appellant Reply Brief at 3-4 (attached at Ex. A). The Second Circuit rejected that argument, relying on the more recent, controlling law from the New York Court of Appeals, *Sykes v. RFD Third Ave. 1 Assocs., LLC*, 15 N.Y.3d 370, 373-74 (2010). See *Stephenson*, 2012 WL 1764191, at *3. Here, plaintiffs’ argument that their membership in a “known” subset of all prospective investors satisfies the “known party” prong of the *Credit Alliance* test should be rejected under the same rationale that the Second Circuit adopted in *Stephenson*. Plaintiffs’ failure to plead that Morgan Stanley knew the specific identity of King County or ISL in the *King County* action, or King County, Butterfield, or SEI Strategies in the *ADCB* action, provides an alternative ground for dismissal in addition to that set forth in Morgan Stanley’s motions for partial reconsideration dated May 17, 2012. See *King County*, Dkt. No. 248; *ADCB*, Dkt. No. 410.

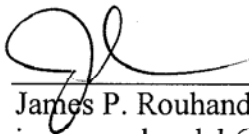
CONCLUSION

For these reasons, the Court should grant defendants' motion for reconsideration and dismiss plaintiffs' negligent misrepresentation claims.

Dated: May 22, 2012
New York, New York

Respectfully submitted,

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Exhibit A

11-1204-cv

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

G. PHILIP STEPHENSON, AS TRUSTEE OF THE PHILIP STEPHENSON
REVOCABLE LIVING TRUST,
Plaintiff-Appellant,

v.

PRICEWATERHOUSECOOPERS, LLP, AN ONTARIO
LIMITED LIABILITY PARTNERSHIP,
Defendants-Appellees.

*On Appeal from the United States District Court
for the Southern District of New York (New York City)*

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POINT I

PLAINTIFF'S NEGLIGENCE/MALPRACTICE CLAIM SHOULD BE REINSTATED

A. PLAINTIFF'S COMMON-LAW CLAIM IS NOT PREEMPTED BY THE MARTIN ACT

Last year, the Appellate Division, First Department, surveyed confusion which had arisen among Federal and some State Courts from its earlier decisions, and clarified that the Martin Act **does not** preempt common-law claims. *Assured Guaranty (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 80 A.D.3d 293 (1st Dept. 2010); *see also Bhandari v. Ismael Leyva Architects, PC*, 84 A.D.3d 607 (1st Dept. 2011). Its determination was not an “about-face”, as PWC claims (at 17), but a clarification of the State Courts’ long-held but poorly-recognized view that common-law claims were not abrogated by implication with the Martin Act’s enactment. *Id.* at 299-300. Since *Assured Guaranty* was decided, the Second Department has (again) echoed that view. *Caboara v. Babylon Cove Devel., LLC*, 82 A.D.3d 1141 (2nd Dept. 2011). As plaintiff has demonstrated (Main Brief at 14-18), **none** of the four Appellate Divisions support Martin Act preemption. Moreover, the New York Court of Appeals’ holding in *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership*, 12 N.Y.3d 236, 245 (2009) has clearly telegraphed that Court’s similar conceptual framework of the Martin Act’s scope. *See Caboara*, 82 A.D.3d at 1142.

In accord, District Courts in this Circuit have recently rejected Martin Act preemption of common-law claims. Judge Kaplan recently concluded:

This Court's duty in interpreting state law is to predict what the New York Court of Appeals would hold were it to decide the matter at hand. In light of changed circumstances and the many legal and policy reasons that argue against preemption, this Court is persuaded that the Court of Appeals would hold that the Martin Act does not preempt common law causes of action that "do not derive from or rely upon the Martin Act to establish a required element of the claim."

Schwarz v. ThinkStrategy Cap. Mgmt LLC, 2011 WL 2732218 at *4 (S.D.N.Y. 2011); *see also Schlesinger v. Valspar Corp.*, 2011 WL 4459070 at *7 (E.D.N.Y. 2011); *In re Bernard L. Madoff Inv. Sec. LLC*, 2011 WL 4434632 at *23-*24 (Bkcy. S.D.N.Y. 2011); *Waverly Properties, LLC v. KMG Waverly, LLC*, 2011 WL 4152538 at *14 (S.D.N.Y. 2011). Some District Courts have held back from embracing that view, avowedly feeling constrained to look to this Court or the New York Court of Appeals to "right the ship". *See* PWC Brief at 18-19. But this Court is not similarly restricted. *See, e.g., Pahuta v. Massey-Ferguson, Inc.*, 170 F.3d 125, 134 (2nd Cir. 1999). The position of the New York Courts is now clear and, respectfully, should inform this Court's decision, in keeping with the guiding principles of federalism and deference expressed by this Court in *Castellano* and cited by PWC (at 16). There is no reason to expect that any future explicit pronouncement from the New York Court of Appeals would depart from the recent, unanimous holdings of its intermediate

appellate courts.

**B. PLAINTIFF HAS SUFFICIENTLY ALLEGED
PWC’S LEGAL DUTY**

Plaintiff alleges all facts necessary to successfully plead “near-privacy”. First, plaintiff alleges that PWC knew that its audit and accounting work for GS was to be used for “particular purposes” – evaluating the investment decision with respect to GS (*e.g.*, A393-96@18-26; A397-99@29-34; A417-21@83-90); the District Court did not discredit those allegations. PWC does not argue differently on this appeal.

The Complaint also sufficiently pleads that plaintiff was a “known party”. First, plaintiff was not part of the “investing public at large”, but of a small and defined class of prospective investors. GS was limited to 500 partners (A420@86k); was *not* publicly traded (A134); had minimum capital contributions of \$1,000,000 (A134, A138); and was limited by Reg.D (“Limited Offers & Sales”) to “accredited investors” (*e.g.*, net worth exceeding \$1,000,000) and ICA2(a)(51) “qualified purchasers” (*e.g.*, over \$5,000,000 in investments) (A142). This meets the “known party” requirement. *See LaSalle Natl. Bank v. Duff & Phelps Credit Rating Co.*, 951 F.Supp. 1071, 1092-94 (S.D.N.Y. 1996); *White v. Guarente*, 43 N.Y.2d 356, 363

(1977).¹

Moreover, Stephenson was certainly a “known party” upon joining GS as a \$60 million investor – 20% of the fund’s entire “value”. (See A387; A462.).² PWC does not deny this, nor could it: its audit reports were specifically addressed to GS partners; and its GS Audit Plan identified its primary responsibility as delivering services to GS shareholders (A418@84,85). At the time plaintiff made its June 1, 2008 investment, Stephenson had received audit reports and other information as a partner of GS and which were addressed to him by PWC as such (A397-98@28-32). The June 2008 execution of a new, separate and binding subscription agreement named a Trust as a “new partner” pursuant to the GS Partnership Agreement (A194@5.01) and with funds in a new capital account (A397@28-30); this is hardly merely “technical”.

Plaintiff also sufficiently alleged that PWC intended plaintiff and others to rely upon the audit reports. As to potential investors:

-- PWC knew GS interests were not publicly traded, and its approval of

¹ The cases cited by PWC (at 24-25) do not require that a “known party” be a “specifically known individual”, but instead endorse the view in *White* that a delimited class of persons may satisfy that requirement.

² PWC set a materiality threshold for its audit of 1% of asset value, or less than \$3,000,000 (A409-10@66), making Plaintiff’s large investment in GS a required focus for individualized attention and confirmation.

valuation of the interests was therefore of primary importance to potential and existing partners (A418-19@85-86);

-- PWC knew the financial statements and audit reports were used in marketing the partnership (A64-65@113-114), and were specifically used in plaintiff's evaluations (A66@118);

– GS had no operations, and could have no lenders, making prospective and existing partners the primary target of PWC's audit report (A419@86e-f);

– PWC reviewed and approved marketing materials plaintiff saw and PWC knew and intended for prospective investors to rely thereon (A395@21-22);

-- PWC consented to the description of its services in the private placement memorandum provided to them, intending that the description be relied upon (A49@64; A395@21; A417@83); and

-- on their face, the audited financial reports contained no restrictions on use (A419@86).

Plaintiff has sufficiently alleged additional facts demonstrating PWC's intent that the limited class of potential investors would rely upon its audit services in making investment decisions.

PWC concedes, as it must, that it intended existing partners to rely upon its services (A418@84). Thus, this aspect of the *Credit Alliance* test is amply met as to

plaintiff's execution of the June 2008 subscription agreement.

The "intent to rely" element of near-privity is satisfied. *See AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 222-23 (2nd Cir. 2000); *Rodin Properties-Shore Mall, N.V. v. Ullman*, 264 A.D.2d 367, 368-69 (1st Dept. 1999).³

Finally, plaintiff has sufficiently alleged "linking conduct". As to prospective investors,

PWC's consent to GS's use of its name, materials, and audit reports in solicitation of investors establishes such conduct (A419@86); moreover, since financial results could not be verified by public trading data (A419@86a), verification of GS's statements and values by PWC was critical to plaintiff and others making an investment decision (A421@88-90). This is sufficient "linking conduct". *See Anwar v. Fairfield Greenwich Ltd.*, 728 F.Supp.2d 372, 435 (S.D.N.Y. 2010).

As to existing investors, the linking conduct is even clearer: the audit reports are addressed directly to the partners, and plaintiff further alleges PWC's provision

³ The "disclaimer" in PWC's engagement letter (never shown to plaintiff) as to "third parties" is irrelevant, since direct addressing of the letter to partners clearly excludes them from "third party" status, as does the course of conduct demonstrating intent that prospective and actual partners rely upon its work. *See, e.g., Caiola v. Citibank, N.A.*, 295 F.3d 312, 330 (2nd Cir. 2002). PWC's sole legal authority, *Thomas H. Lee Equity Fund V, LP v. Grant Thornton, LLP*, 586 F.Supp.2d 119, 123-24 (S.D.N.Y. 2008), is inapposite, since its plaintiffs were excluded from the scope of liability by name, in separate "access letters" directed to them, as to the specific subject of the lawsuit.

of additional financial and tax information to partners. (A417@83; A391@14).

“Near-privity” has been sufficiently pleaded. *See Barrett v. Friefeld*, 64 A.D.3d 736, 738 (2nd Dept. 2009).

C. PLAINTIFF HAS SUFFICIENTLY ALLEGED CAUSATION

PWC posits (at 28-29) an alleged lack of transaction causation (a ground not embraced by the District Court). Transaction causation “is established simply by showing that, but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the ... transaction.” *Emergent Capital Inc. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2nd Cir. 2003).

PWC points primarily to the circumstance that plaintiff did not physically possess PWC’s opinions prior to initially investing; this is immaterial. Stephenson was accurately told by GS that: PWC was its auditor; PWC had issued an unqualified opinion for 2006; and it would do so for 2007 (A396@24-25). If PWC had issued a qualified opinion (or refused to issue an opinion), plaintiff would never have invested (A397-98@30-31). This is sufficient. *See AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 209-10 (2nd Cir. 2000).⁴

⁴ PWC’s citation to *SIPC v. BDO Seidman, LLP*, 222 F.3d 63, 73-74 (2nd Cir. 2000) is unavailing. In that case, misrepresentations were made only to regulators, and were not alleged to have been made to or received by customers “in any form”.

PWC's focus upon plaintiff's receipt of "financial statements", in distinction to the audit opinion, is misplaced: plaintiff alleges that the reliability of the vehicle, established by PWC's imprimatur, was of critical importance to his investment decision, more than details of any line item. PWC ignores that, prior to making his initial investment decision, plaintiff received and relied on financial information based on PWC audit work: "tearsheets" of financial performance for the substantially identical Fairfield Sentry fund (also audited by PWC) (A396@24-26).

In any event, prior to the Trust becoming a new partner in June 2008, plaintiff had physically received and reviewed the PWC audit opinions, and relied upon them in executing a separate subscription agreement and establishing a new account. (A397@29).

Such is not the case here. Indeed, *Seidman's* use of that phrase connotes that a plaintiff need only receive and rely upon the information, whether orally or in writing. Likewise, *Security Pac. Bus. Credit v. Peat Marwick Main & Co.*, 79 N.Y.2d 695, 705-06 (1992) is inapposite, as plaintiff was not an intended recipient of the audit report, but a lender who called an auditor to inquire about ongoing work.

POINT II

THE DISMISSAL OF PLAINTIFF’S FRAUD CLAIM SHOULD BE REVERSED

A. PLAINTIFF’S ALLEGATIONS OF PWC’S AUDIT FAILURES SUFFICIENTLY ESTABLISH SCIENTER

An auditor is engaged not to accept financial statements uncritically, but to examine, express skepticism, and obtain confirmation – or must qualify its report or refrain from giving approval. Plaintiff has alleged PWC’s professional obligations, internal standards, and contractual undertakings in its audit of GS. The foundation of the audit is evaluation of internal control, in order to obtain confidence that information is captured accurately and enable a report to be issued under GAAS. However, at each stage of the process, PWC – by its own admission – affirmatively determined to uncritically accept the financial statements as presented by GS, without performing the additional auditing work plaintiff alleges was required by GAAS. GS itself did no business, but was a passive vehicle for money being handed over to BMIS for “investment”.⁵ Under specifically alleged GAAS principles, BMIS was deemed a service organization of GS. PWC was obligated by GAAS to assess and review BMIS’s internal controls directly, or through the workpapers of BMIS’s

⁵ GS was managed by its general partner, Fairfield Greenwich Bermuda (“FGB”), which was not audited by PWC or any other firm, and so its internal controls were not evaluated (A405@53-54).

auditor and assure itself in turn of its qualifications and reliability. PWC did not perform such assessment (and could not have, since BMIS refused access as a matter of practice), and PWC did not (and could not) satisfy itself of the adequacy of its “auditor’s” work. Plaintiff has sufficiently alleged that PWC did not evaluate GS’s internal control and could not issue an unqualified (or any proper) opinion under GAAS.

PWC’s failures therefore go far beyond “shoddy” and reach the level of “amounting to no audit at all”. PWC affirmatively determined, in the face of its professional obligations and facts within its knowledge requiring further investigation, to disclaim its responsibility to look further, essentially admitting that it did not do what plaintiff has alleged GAAS required it to do. That makes this case different from other BMIS-related actions, where no such allegations are present.

In determining whether Plaintiff has sufficiently alleged scienter, this Court has ruled: “... the inference may arise where the complaint sufficiently alleges that the defendants ... (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 monitor...” *Novak v. Kasaks*, 216 F.3d 300, 311 (2nd Cir. 2000). Plaintiff sets forth facts amply meeting these criteria, and PWC’s contentions on appeal are no more than a shell game, using isolated phrases from other cases without reference to the

applicability of their facts to *this* pleading.

PWC attempts to lump this complaint in with others which have unsuccessfully attempted to hold auditors liable in BMIS-related cases. That attempt is misplaced. A review of the complaints in those cases reveals that none: identify the specific GAAS obligations to evaluate internal controls of BMIS as a service organization; link allegations of PWC's inaction to its audit failures; correctly identify red flags within PWC's knowledge or alleging bases for such knowledge; or allege PWC's unique position as the auditor of the vast bulk of BMIS feeder funds.

PWC calls it "absurd" that it "knew or should have known more about the Madoff scheme than any other entity on earth". Stripping out the hyperbole, PWC *was* in a different position from other auditors of BMIS funds; as alleged, PWC Canada alone was auditing more than \$7 billion through the Fairfield funds, and the interconnected PWC firms were auditing more than BMIS claimed to have under management (A461-69@199-212). This puts PWC in a unique position to both evaluate the internal controls at the funds, and to know and appreciate the significance of the red flags alleged herein. It is not the same as any other BMIS fund auditor, and this is unlike any of the other complaints.

The first alleged auditing failure is that PWC knew of and recklessly ignored the lack of effective internal controls at GS, and the consequent risk to its financial

statements. PWC's position (at 43), that it relied upon GS's (and FGB's) claims that they were performing oversight of BMIS, in fact supports plaintiff's claim. Under GAAS and PWC's own audit methodology, such blind reliance is reckless (A426@103; *see also* A405@51,53-54; A407@60; A409@65; A410@67,69a; A423-25@95,97-102). Plaintiff alleges that GS had no independent business, but was merely a passive vehicle for the entrustment of partners' investments over to a third party, BMIS. In order for its financial statements to have the appearance of reliability, GS had to, and did, represent that it amassed data to verify that the third party was properly handling the investments. Plaintiff alleges further that, as GS's auditor, PWC was obliged to confirm that these procedures were followed and data collected, and not merely rely upon the audit client's representations. Moreover, since it was and is widely known that BMIS did not supply such data to investors or funds (because it did not exist), PWC in doing its audit of GS's "internal controls" must *ipso facto* have known of their inadequacy.⁶

Plaintiff's second allegation of auditing failures is that PWC was obliged to, but did not, examine BMIS's records and operations as a "service organization" as part of GS's information system, as it was required to do by GAAS. PWC's sole

⁶ The only alternative to this conclusion is that PWC did not even examine the supposed internal controls of GS, which makes its audit "no audit at all".

response is invocation of the irrelevant conclusion that it “was not hired to audit Madoff’s business or issue an opinion on Madoff’s financial statements”, citing *Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, 747 F. Supp.2d 406, 413 (S.D.N.Y. 2010) and *In re Tremont Sec. etc. Litig.*, 703 F.Supp.2d 362, 371 (S.D.N.Y. 2010). However, neither of those Courts were presented with the allegations in the Second Complaint, establishing that PWC was required by GAAS, as part of its audit of GS, to treat BMIS as a service organization and obtain satisfactory confirmations from BMIS.⁷ Thus, their holdings are of no guidance here, where the specific auditing failures and bases therefor are alleged. Plaintiff’s do not allege that PWC was required to “audit” BMIS, but were required by GAAS to perform work, in the scope of **the audit of GS**, to confirm **GS’s** assets and transactions, when such are held and effected by a service organization, This does not “expand” the obligations of auditors to their audit clients beyond what GAAS has long required.

Plaintiff alleged, third, that if confirmation of adequate internal controls was not forthcoming from BMIS, PWC was obliged by GAAS to satisfy itself of the

⁷ Neither complaint made reference to the term “service organization”, the relevant AU standards, or contended that such obligations arose under GAAS, and therefore provided those Courts with no “basis” by which it could find the auditing failure alleged in detail here.

reliability of the report and work of BMIS's auditor, F&H. Plaintiff has sufficiently alleged, and PWC has not disputed, that F&H's work was not reliable, and F&H itself could not have been relied upon to confirm GS's financial statements (*see* A442-A445 (including allegation that F&H represented to AICPA that it did not do auditing)). Therefore, either: (1) PWC knew the foregoing, but recklessly did not act upon that knowledge and still certified GS's financial statements; or (2) PWC did not know it, because it did not investigate F&H. In either event, Plaintiff has sufficiently alleged a reckless auditing failure under GAAS which presents a risk of material inaccuracy in GS's financial statements. PWC's contention that plaintiff must demonstrate at this stage that PWC had "actual knowledge" of this fact is a misplaced reference to the case law in *South Cherry*; there, defendant Hennessee Group was not an auditor, and the possibility that it "would have learned" something if it had done promised due diligence carried with it, according to the *South Cherry* Court, only the trappings of breach of contract. Here, PWC was obliged to perform its audit work according to GAAS, and a combination of audit failures and disregard of red flags by an auditor will suffice to establish scienter.⁸

⁸ PWC's citations are inapposite. In both *Anwar*, 728 F.Supp.2d at 452, and *Meridian*, 747 F.Supp.2d at 413, F&H's inadequacy was pleaded *as a red flag*, as to which knowledge or wilful blindness was not shown; here, Plaintiff alleges an affirmative GAAS obligation to investigate F&H, which cannot be disclaimed with (and is supported by) PWC's contention that it had no obligation to examine F&H.

Plaintiff alleges, fourth, that PWC was thereupon obliged to independently verify existence of assets and trading activity, to confirm the accuracy of GS's financial statements. PWC attempts to evade this obligation with mere semantic quibble about the terms "would have" and "should have". Plaintiff's allegations of PWC's failures are clear: when alleging that PWC "should have" done something, it is because it was required to do so by GAAS, an entirely appropriate allegation of audit failure; where alleging that investigation "would have" led to discovery of further facts, it is an allegation either that an audit failure was thereby material to the risk of misstatement, or that a red flag would, in the absence of alleged wilful blindness, have alerted PWC to the risk of misstatement. Both are entirely in keeping with this Court's pleading requirements for scienter.

Fifth, plaintiffs alleges that PWC's handling of management fees charged by GS's general partner constituted an audit failure. As plaintiff alleges, FGB's sole "value added" was its purported due diligence, monitoring and verification of BMIS. With no other business conducted at GS, the propriety of fees charged for this "service" was clearly within the scope of its audit. Yet as to this, PWC's sole position is that it "was [] entitled to rely on the representations of Greenwich Sentry and its general partner". Since a related entity was earning fees for work it claimed it did for GS, PWC's inquiry obligation was, if anything, enhanced. As is set forth

with respect to the first Auditing Failure *supra*, plaintiff sufficiently alleges that PWC did not have this luxury under GAAS.

B. PLAINTIFF’S ALLEGATIONS OF “RED FLAGS” SUFFICIENTLY ESTABLISH PWC’S SCIENTER

Having established failures which destroy the reliability of the PWC “audit” under GAAS, plaintiff alleged seven detailed red flags which were known to PWC or, if they were not “known”, were so obvious to a reasonable auditor in its position that the failure to heed them constituted recklessness or wilful blindness. Where plaintiff pleaded knowledge, it set forth facts in PWC’s own practices, its professional obligations, and its statements which provide a basis for such allegation. Singly or in combination, these red flags gave notice of the serious risk of material misstatement in GS’s financial statements.⁹

As the first “red flag”, Plaintiff alleged (uniquely among Madoff-related complaints) that, under GAAS, the status of BMIS *as a service organization* gave rise to an increased level of operational risk which, in the absence of effective

⁹ There is no requirement that red flags would have “uncovered Madoff’s complex ... fraud” (PWC Brief at 2, 12, 48). PWC was not charged with being auditor to the world of all wrongs, just with making certain that GS’s financial statements were not subject to a material risk of misstatement, and that its unqualified audit report thereon was not fraudulent as a result.

oversight, rendered the financial statements of GS inherently unreliable. The District Court, solely on the strength of its earlier finding as to a substantially less detailed set of allegations in the First Complaint, found without further discussion that this was “too mild”, a conclusion which merits *de novo* review, in light of the specific auditing standards alleged. PWC’s only support for this unexplained holding is case law as to other Madoff-related complaints, but these plead centralization of function without ascribing the particular significance to the audit process which Plaintiff does, and without specifying the auditing standards which establish the criticality of the “operational risk” generated therefrom. Further, this centralization of function and operational risk is a backdrop to the “holistic analysis” which this Court must perform, and which the District Court declined to do: all of the suspicion created by each of the other “red flags” is heightened when viewed against the fact that the reported results were not confirmed to PWC, were refused to be confirmed by BMIS, and were entirely within BMIS’s control.

The second “red flag” is unique to PWC: the fact that it was auditing significantly more in reported values of BMIS funds, than BMIS publicly reported to the SEC. PWC merely disclaims “actual knowledge” of this red flag, ignoring entirely the extensive allegations which create a strong basis for alleging such knowledge: PWC purposefully creates databases and networks of information

sharing containing this information; establishes practice groups for meeting and sharing this information; and has its own organizational incentives to acquire and share knowledge of the amount of BMIS funds its global firm was auditing (Main Brief at 40-46). This is not a “public library” to which PWC had access, but a collection of information which *it created and utilized* for professional and corporate purposes.¹⁰ This is not an arcane fact; knowing the volume of BMIS feeder funds under audit was important to PWC, and enabled the sister firms to more effectively audit the multiple BMIS feeder fund clients. Plaintiff also pointed to actual sharing of information about BMIS among sister firms (A415-16@77-78), allegations which PWC ignores.

The third “red flag” is that PWC knew and ignored the impossibility that BMIS was trading at the levels it reported. The sole question is whether plaintiff has sufficiently alleged, at this stage, a basis for PWC’s knowledge of the huge anomaly between BMIS’s purported trading volume and market trading levels. This allegations with respect thereto are reviewed in detail in the Main Brief at 46-48, and

¹⁰ PWC’s claim (at 51 n.2) that sharing information among member firms would violate “client confidentiality” is untenable, since: (1) as plaintiff alleges, this information is kept in shared databases and regularly consulted for professional purposes (A411-17); (2) information as to Madoff’s reported trading levels is, by PWC’s own argument, not “client” information; and (3) the claim is outside the record for purposes of this motion.

are not substantially denied by PWC at this stage. The discrepancy between the trading levels and market volume created a material risk of misstatement of GS's financials, such as would be obvious to a reasonable auditor in the conduct of its work, supporting a finding of scienter.

The fourth red flag is the impossibility of achieving BMIS's reported returns given its reported trading methods, which both increased risk and employed non-market constraints which would only reduce returns (*see* Main Brief at 49-52). The District Court did not discredit the allegations of PWC's knowledge of each of these factors, but held that market success alone does not support a finding of scienter. This fails to appreciate the risk of misstatement arising from the report of high returns in the market context and rules which BMIS reported that it operated, which plaintiff alleges are uniquely obvious to a reasonable auditor in the course of evaluating the BMIS strategy. It is the auditor's job to evaluate the investment vehicle in its market context. No other pleading has asserted this combination of factors, making conclusions of other courts (cited by PWC) about "market success" irrelevant to this pleading.

Fifth and sixth, plaintiff alleged that the options trading described by BMIS could not have been occurring at the levels and in the manner represented. Plaintiff's Main Brief (at 52-56) sets forth in detail the allegations demonstrating that this was

apparent to PWC, but recklessly ignored. The District Court took this to be an allegation of an audit failure, not a red flag, and PWC now takes up that refrain, feigning ignorance of the markets which its standard audit methodology and specific Audit Plan for GS required them to track and evaluate. The Complaint has set forth a sufficient basis for PWC's knowledge of facts which would cause a reasonable auditor to inquire further, squarely meeting the *Novak* standard for demonstrating scienter.

C. THE REQUIRED HOLISTIC ANALYSIS DEMONSTRATES PWC'S SCIENTER

The District Court declined to meaningfully evaluate the combined effect of the red flags, which reach to every aspect of the BMIS operations and therefore materially increased the risk that GS's financial statements were misstated. In evaluating the red flags using the required holistic analysis, it is important to return to this Court's guidance that an inference of scienter : "may arise where the complaint sufficiently alleges that the defendants ... (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 monitor..." *Novak*, 216 F.3d at 311. Plaintiff's Main Brief (at 56-62) supplied the necessary holistic review of the multiple

red flags, which PWC ignores.

Some District Courts have dismissed Madoff-related claims where plaintiffs have failed to allege auditors' knowledge of individual red flags, or by failing to find any obligation to critically examine BMIS operations, or discounting red flags as individually unpersuasive. These cases are inapposite, and the analysis of the District Court below is infirm, because:

(1) Plaintiff has articulated PWC's clear and uncontested obligation under GAAS to critically examine BMIS's internal controls as part of its audit work of GS, with the result that (since GS did no "business" of its own), such confirmation was required if PWC was to be conducting "any audit at all". None of the other cited cases contain those allegations.

(2) Plaintiff has sufficiently alleged the bases of PWC's knowledge of each of the red flags, which are themselves pleaded in greater detail than in each of the cases cited by defendants. Plaintiff has further established that PWC was in a unique position among auditing firms to see and appreciate the significance of the red flags (*see* particularly Red Flag #2).

(3) Plaintiff has set forth reasons why each of the red flags put PWC on notice of the material risk of misstatement of GS's results. Respectfully, the focus of other plaintiffs and the other courts on whether the red flags would have "uncovered

the Madoff fraud” is misplaced. Plaintiff has alleged that PWC knowingly issued unqualified audit opinions on GS’s financial statements when it had no basis to do so under GAAS; this is all that is required to establish scienter. Moreover, as this Court recognized in *Novak*, the red flags need only prompt the auditor’s duty of further investigation, as those alleged by plaintiff clearly do.

When the foregoing factors are considered, the significance of the red flags, taken together, is clear: PWC was obliged to evaluate the risk of misstatement in GS’s results, but could only properly perform its audit by in turn evaluating BMIS’s internal controls. In the course of a proper audit, PWC was inevitably faced in each aspect of its audit work with facts which demonstrated the risk of material misstatement. PWC’s position now is to disclaim that it knew those facts, or that because they related to BMIS, they had to know those facts. GAAS obligations disprove the latter, and PWC’s own internally-imposed audit obligations belie the former. Even in the unlikely event that PWC can subjectively profess a lack of the doubt which these red flags necessitated, their blithe willingness to give approval to GS’s financial statements amounted to recklessness which supports a finding of scienter. *See, e.g., In re Philip Services Corp. Sec. Litig.*, 383 F.Supp.2d 463, 475 (S.D.N.Y.2004)(“because the red flags would be clearly evident to any auditor performing its duties, one could reasonably conclude that [the auditor] must have

noticed the red flags, but deliberately chose to disregard them”).

D. PLAINTIFF HAS SUFFICIENTLY ALLEGED RELIANCE

Plaintiff’s investment decisions relied heavily upon PWC’s issuance of unqualified audit opinions. Those audit opinions were accurately conveyed initially to him orally, by GS’s general partner, and plaintiff first invested in April 2008 in reliance thereon. He later received paper copies, and again in reliance on their unqualified nature, determined effective June 2008 to make the Trust a new partner in GS and establish a new capital account, as the GS agreement required. In further reliance on those opinions, plaintiff maintained his investment in GS until December 2008, when GS suspended redemptions. (A395-99@21,24-26, 28-30,34).

“A plaintiff suing for fraud need only allege that he relied on the misrepresentations made by the defendant in order to overcome a motion to dismiss. Indeed, the reasonableness of his reliance implicates factual issues whose resolution would be inappropriate at this early stage.” *Bangkok Crafts Corp. v. Capitolo Di San Pietro in Vaticano*, 2006 WL 1997628 at *8 (S.D.N.Y. 2006).

The fact that plaintiff did not initially physically possess PWC’s unqualified audit opinions in writing is irrelevant. An actionable misrepresentation may be made orally, as long as other requirements (e.g., duty and causation, addressed in Point I)

are met. *See, e.g., Graubard Mollen Dannett & Horowitz v. Moskovitz*, 86 N.Y.2d 112, 122 (1995). Plaintiff was accurately told by GS's general partner that PWC had issued, and was about to again issue, unqualified audit opinions. Plaintiff's decision hinged on knowing that GS's remarkable results had been investigated and confirmed by a reputable auditor, and he received that assurance.¹¹ This is sufficient to demonstrate reliance.

A representation conveyed through a third party may be the basis for a fraud claim, particularly where, as here, the party conveying the information is the securities seller communicating the auditor's results to a prospective investor. *See Amusement Indus., Inc. v. Stern*, 693 F.Supp.2d 327, 348 (S.D.N.Y. 2010); *Carofino v. Forester*, 450 F.Supp.2d 257, 268-69 (S.D.N.Y. 2006); *Powers v. Ostreicher*, 824 F. Supp. 372, 376 (S.D.N.Y. 1993); 2 NYPJI3d 3:20 at 165 (2009). Even PWC's cited decision, *SIPC v. BDO Seidman LLP*, 95 N.Y.2d 702, 710 (2001), notes the "general and unremarkable principle that liability for fraud can be imposed through communication by a third party".

Thus, PWC's assertion that plaintiff "received" the reports only after he invested is untrue. Indeed, its cases illustrate the fallacy of its position. In both

¹¹ The audit opinions are one paragraph in length, and contain only five operative words: "present fairly, in all material respects". The significance is the assurance which that unqualified endorsement imparts (A387@2, A395-96@21-24).

P.Chimento Co. v. Banco Popular de Puerto Rico, 208 A.D.2d 385, 386 (1st Dept. 1994) and *Eurycleia Partners, LP v. Seward & Kissel, LLP*, 46 A.D.2d 400, 403 (1st Dept. 2007), the misrepresentations were clearly made to the plaintiffs AFTER the investment decisions. Here, the audit report for 2006 predated plaintiff's initial investment decision; the 2007 audit report was also accurately described as imminent and unqualified prior thereto.

Moreover, Stephenson actually possessed and relied upon both reports prior to the decision to have the Trust become a new GS partner in June 2008. (A397@29-30). Reliance is sufficiently alleged.

Finally, PWC's assertion that Plaintiff did not know which specific PWC International member firm had issued the unqualified audit opinion is entirely irrelevant; as the Complaint alleges, what was significant to plaintiff was that the audit was done by a PWC firm, in light of its reputation (A395@21-23). There is nothing about the identity of the member firm signing the audit opinion which "attenuates" that reliance.

POINT III

PLAINTIFF HAS STANDING TO ASSERT ITS CLAIMS

The District Court correctly held that plaintiff's negligence and fraud claims were direct, at least to the extent of his inducement to invest (SPA20). PWC urges as an alternative ground for affirmance (at 30, 61-62) that the claims are derivative.¹²

As PWC concedes, the District Court articulated the correct legal standard, inquiring: "(1) who suffered the alleged harm ...; and (2) who would receive the benefit of any recovery or other remedy..." (SPA13-14, *citing Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004)). PWC asserts (at 33, 61-62) that Plaintiff was hurt only because GS was hurt, and was hurt equally with GS and all other GS partners.

Plaintiff's claims are undeniably "direct" under the *Tooley* analysis, as they are asserted neither on behalf of or in the right of the partnership, but seek redress for injury specific to Plaintiff caused by PWC's misconduct. *See, e.g., Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2nd Cir. 1995); *Bernstein v Arthur Andersen & Co.*, 210 A.D.2d 193, 194 (2nd Dept. 1994).

¹² Factual averments as to standing, made without benefit of discovery, are not required to be pleaded in great specificity, and such allegations must be accepted as true. *See Building and Const. Trades Council v. Downtown Dev., Inc.*, 448 F.3d 138, 145 (2nd Cir. 2006); *see also Baur v. Veneman*, 352 F.3d 625, 631 (2nd Cir. 2003).

The harm was uniquely suffered by plaintiff. Plaintiff's investment decisions were based on PWC's unqualified audit opinions (A395-99@21-34). Thus, the claims are clearly direct:

where a claim pertains “to fraudulent misrepresentations, not merely mismanagement of the Funds ... [] the Investors may assert a fraud claim based on the theory that they were induced to make and/or retain their investments.”

Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Sec., LLC, 446 F.Supp.2d 163, 205 (S.D.N.Y. 2006) (citation omitted); *see also Primavera Familienstiftung v. Askin*, 130 F.Supp.2d 450, 494-95 (S.D.N.Y. 2001). This accords with the District Court's finding that Plaintiff was directly injured differently from GS as a whole, because Plaintiff “knew of PWC's unqualified audits prior to investing in Greenwich Sentry, and ‘would not have made its initial investment in Greenwich Sentry’ if not for PWC's opinion. (Cl.¶268.)” (SPA20).

Plaintiff invested relatively late in the Ponzi scheme. Plaintiff invested again by executing a new subscription agreement (placing Plaintiff in a unique position). Moreover, plaintiff took **no** cash distributions or redemptions -- unlike many partners who profited from GS (A398-401@31,35-40). Plaintiff was thus not injured in the same proportion as other partners. As the District Court recognized (SPA 20), Plaintiff relied upon PWC's audit opinions for 2006 and 2007, and would have

different claims from earlier investors who relied upon different auditors and their opinions. Owing to the Ponzi scheme, Plaintiff's capital actually benefitted any partner redeeming after he invested -- particularly if it was retained at GS and used to fund other partners' redemptions (A400@38). The harm was clearly "differentiated", not proportional to interests in the partnership, and based upon individual investment decisions, and are direct. *See In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 371 n.112 (Del.Ch. 2008); *Higgins v. N.Y. Stock Exchange, Inc.*, 10 Misc.3d 257, 273-75 (Sup.Ct.N.Y.Co. 2005.).

Conversely, GS did not suffer harm. GS was not a conventional business, but was a passive vehicle by which individuals desiring to invest in BMIS's "strategy" could do so with the comfort that PWC had investigated and approved its safety. Plaintiff and other partners made individual investment and redemption decisions, not coordinated by GS or otherwise. Thus, as an entity, GS did not rely upon and was not harmed by the wrongs alleged. "[A]llegations by investors of having been tortiously induced to invest or to retain an investment are not derivative claims." *Anwar v. Fairfield Greenwich Ltd.*, 728 F.Supp.2d 372, 401-02 (S.D.N.Y. 2010) (also distinguishing *Continental Cas. Co. v. PricewaterhouseCoopers, LLP*, 15 N.Y.3d 264, 270-71 (2010), cited by PWC). PWC's other cited cases all admit that where a plaintiff can show individualized harm, the claim is direct; their facts are not akin to

those present here, rendering them inapposite beyond that proposition.

Further, as a conduit for money to flow from investors to Madoff, GS was an integral part of the Ponzi scheme (A419@86(e)). Indeed, to the extent that GS kept investors' money in its own accounts and paid redemption requests out of such funds based on the audited financials by PWC, it operated as a freestanding Ponzi scheme (*see* A400@38). Thus, GS has not been damaged. *See Hirsch*, 72 F.3d at 1094; *Knauer v. Jonathon Roberts Financial Group, Inc.*, 348 F.3d 230, 234 (7th Cir. 2003).

The benefit of recovery in this suit would accrue to Plaintiff individually. The nature of the harm in a Ponzi scheme is not to the vehicle, the partnership, but to those individual investors who lost money uniquely and individually. It is firmly established that, where the corporation is itself at least in part at fault for the losses to shareholders, it is barred from recovery, and the claim is reserved for shareholders. *See AIG, Inc. v. Greenberg*, 976 A.2d 872, 883 (Del.Ch. 2009). Further, where the effect of a fraudulent nondisclosure has the effect of treating partners unequally, the injury is to the individual shareholders and not the investment vehicle itself. *See Anglo American Security Fund, LP, v. S.R. Global Int'l Fund, LP*, 829 A.2d 143, 153-54 (Del.Ch. 2003); *Pozvez v. Ethanol Capital Mgmt., LLC*, 2009 WL 2176574 at *10-11 (D.Ariz. 2009) (applying Delaware law); *Newman v. Family Mgmt. Corp.*, 748 F.Supp.2d 299, 316 (S.D.N.Y. 2010).

Finally, PWC contends that Plaintiff's arguments as to the "holding" claim are not properly preserved for this appeal merely because raised in footnotes – albeit *twice*, and with supporting case law (Main Brief at 5n.3 and 11n.5). The District Court's purported limitation was made in passing, without a modicum of discussion, and was ultimately *dictum* in light of its dismissal of the entire claim on Martin Act grounds. The superseding Second Complaint therefore omitted *any* negligence claim, and leave is sought in this Court to include a full negligence claim in a new pleading upon remand; nonetheless, plaintiff further preserved the argument by citing to two authorities directly permitting "holding" claims. Plaintiff respectfully submits that this Court may and should permit assertion of this claim, pursuant to its own discretion, particularly given the false and entirely unexplained dichotomy between the inducement and holding claims assumed by the District Court, the lack of surprise to PWC, the lack of merit in PWC's own attempt to craft such a distinction, and the *de novo* standard of review on this appeal. *See Milanes v. Napolitano*, 354 Fed. Appx. 573, 574 (2nd Cir. 2009).

CONCLUSION

Plaintiff-appellant respectfully requests that this Court reverse the District Court's dismissal of the negligence/malpractice claims in the First Complaint, and permit Plaintiff to assert such claims in an amended pleading; and reverse the District Court's dismissal of the Second Complaint.

Dated: October 25, 2011

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