The *Hennessee* Aftermath: Lessons to Be Learned from Merkin and Madoff to Avoid Investing in the Next Ponzi Scheme

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The authors review an important decision by the Second Circuit Court of Appeals and analyze New York State Attorney General Andrew Cuomo's complaint against Ezra Merkin arising out of the Madoff Ponzi Scheme. It also identifies the red flags that the Merkin case raises for investment fiduciaries in performing due diligence when hiring and overseeing investment managers and several best practices that, in the authors' own experience, investment fiduciaries should consider.

In an investment environment rife with failed investments, Ponzi schemes and market meltdowns, investment advisers and feeder fund managers may be breathing a sigh of relief in light of the Second Circuit's recent decision in *South Cherry Street, LLC v. Hennessee Group, LLC*.[1] The *Hennessee* ruling ostensibly raises the bar for individual claim-

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ants to successfully sue advisers and managers for securities fraud. While perhaps better insulated from civil fraud claims, advisers and managers are not out of the woods given the recent activity of various state Attorneys General in the aftermath of Madoff and the lesser standard of proof required for Attorneys General to prosecute individuals for securities fraud**.**

Just ask Ezra Merkin — who recently sold his $300 million art collection to fund a possible settlement with New York State Attorney General Andrew Cuomo — whether investment advisers entangled in the Madoff fiasco should be concerned.

New York Attorney General Cuomo's complaint against Merkin is instructive because it provides a roadmap of possible legal causes of action available to regulators nationwide against investment advisers who recommended investing individual and non-profit organizations money with Madoff and others. It also may shed light on certain standards of due diligence required of investment fiduciaries and asset allocators when recommending investments with third party investment managers and funds.

This article reviews the *Hennessee* decision and analyzes Attorney General Cuomo's complaint against Merkin. It also identifies the red flags that the Merkin case raises for investment fiduciaries in performing due diligence when hiring and overseeing investment managers and several best practices that, in the authors' experience, investment fiduciaries should consider.

THE *HENNESSEE* CASE AND OTHER HURDLES FOR THE INDIVIDUAL INVESTOR

The *Hennessee* case is perhaps the most well known and controversial pre-Madoff Ponzi scheme case where an investor sued an investment manager for failing to detect fraud through its due diligence and for misrepresenting the level due diligence that it would conduct. The fund at issue — Bayou Accredited Fund, LLC ("Bayou") — turned out to be nothing more than a $400 million Ponzi scheme. Bayou's principals pled guilty to defrauding investors and are serving 20 year jail sentences.

South Cherry Street, LLC ("South Cherry") sued Hennessee Group LLC ("Hennessee") for breach of contract, breach of fiduciary duty and

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for violation of §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder (the "10b-5 claim"). South Cherry alleged that Hennessee failed to conduct basic due diligence and, as a result, its "representations and opinions were given without basis and in reckless disregard of their truth or falsity."[2] The district court dismissed all three claims and South Cherry appealed the decision to the United States Court of Appeals for the Second Circuit.

The Second Circuit affirmed the district court's dismissal of the South Cherry's breach of contract[3] and 10b-5 claim.[4] According to the Second Circuit opinion, to state a claim for 10b-5 securities fraud, a plaintiff must plead that in connection with the purchase or sale of securities, the defendant made a false representation as to a material fact, or omitted material information, *and acted with scienter*.[5] In the court's view, the major stumbling block for South Cherry's 10b-5 claim was that, in the court's view, South Cherry failed to meet the scienter pleading requirement. Despite South Cherry's allegation that Hennessee knowingly or recklessly made untrue statements or omitted material facts, the Second Circuit concluded "nowhere in the Complaint is there any allegation that Hennessee Group had knowledge that any representation it made ... was untrue."[6] Further, to the extent that South Cherry sought to allege recklessness, the Complaint does not contain an allegation that Hennessee actually intended to relay false or misleading information about Bayou or to aid in the fraud being perpetuated by the Bayou principles.[7]

In an attempt to distinguish the degree of recklessness required to prove fraudulent conduct as opposed to gross negligence and negligence, the Second Circuit concluded that a person engaging in fraud must act with "conscious recklessness — *i.e.*, a state of mind approximating actual intent and not merely a heightened form of negligence."[8] The court went on to define reckless conduct as conduct that at the least is "highly unreasonable and which represents an extreme departure from the standard of ordinary care… to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[9] To date, complaints in which "conscious recklessness" is successfully proven allege that a defendant has knowledge of facts or access to information contradicting public statements.[10]

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The Second Circuit also addressed whether the Hennessee Group intended to defraud South Cherry with regard to its own due diligence. In other words, did Hennessee's conduct in light of its oral and written representations touting its thorough, highly detailed and ongoing due diligence process rise to the level of fraud?[11] While the Court found it "plausible to infer that the Hennessee Group had been negligent in failing to discover the truth," in its view, South Cherry's factual allegations did not give rise to a strong inference that Hennessee's failure to conduct due diligence reflected an intent to defraud. In reaching this conclusion, the Court remarkably concluded that it was implausible that Hennessee, an industry leader that depended on its reputation, would have risked that reputation by recommending that its clients invest in a fund of which Hennessee had made "little or no inquiry at all."[12] The case does not address the type of information needed to satisfy pleading requirements when claims of negligence and gross negligence are alleged.

Finally, the Second Circuit's decision does not impact Hennessee's April 22, 2009 settlement with the SEC for violation of Section 206(2) of the Investment Advisers Act of 1940 ("Section 206(2)"). Hennessee and its principal agreed to pay a fine and disgorge fees to settle the SEC's charges that Hennessee violated Section 206(2) by misleading its clients regarding its due diligence. Section 206(2) prohibits investment advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(2) does not require fraudulent intent. Instead, the SEC may prosecute an investment adviser for negligent violation of Section 206(2). Section 206(2) does not, however, provide the individual investor with a private cause of action.

THE BROAD POWERS AND REMEDIES AVAILABLE TO THE ATTORNEY GENERAL

Unlike individual investors who have to overcome the "scienter" pleading requirements established by *Hennessee*, Attorneys General, like the SEC, generally do not have to prove that an adviser intended to defraud investors in order to prosecute securities fraud. Indeed, state securities laws broadly empower Attorneys General to seek to enjoin fraudulent conduct, to

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obtain restitution from managers or advisers who engage in securities fraud and to bar them from serving as an investment manager or adviser. These "blue sky" statutes have been actively utilized by Attorneys General across the country to prosecute various former titans of Wall Street.

New York's Martin Act, one of the most powerful weapons in the New York Attorney General's arsenal, permits the Attorney General to investigate and prosecute financial fraud, both criminally and civilly, by anyone doing business in New York State. Under the Martin Act, the Attorney General does not have to prove "scienter." Nor does the Attorney General have to prove that any buyer was actually defrauded or that any sale of securities actually took place. All that is necessary is that the target entity is doing business in New York and is engaged in or is about to engage in fraudulent practices in the "advertisement, investment advice, purchase or sale" of a financial instrument.[13] Notably, the Martin Act also provides that it is illegal to make false statements regarding the purchase or sale of a financial instrument where (i) they knew the truth, or (ii) with reasonable efforts could have known the truth or (iii) made no reasonable effort to ascertain the truth or (iv) did not have the knowledge concerning the representation or statement made."[14] In other words, the Martin Act provides the Attorney General with the flexibility to prosecute an individual for failing to conduct adequate due diligence.[15]

Another powerful weapon available to the Attorney General is New York's Executive Law §63(12). While largely used to combat consumer frauds, the statute is broadly worded to give the Attorney General authority to commence an investigation or an action "whenever any person shall engage in repeated fraudulent conduct or fraud or illegality in the carrying on, conducting or transaction of business."[16] As with the Martin Act, liability is not dependent on proving any intention to deceive investors. "Illegality" within the meaning of §63(12) is the violation of any state law or regulation, and federal law if not preempted.

THE ATTORNEY GENERAL'S ALLEGATIONS AGAINST MERKIN

Ezra Merkin is alleged to have held himself out as an "investing guru" when he instead, was nothing more than a "glorified mailbox." The New

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York Attorney General's case against J. Ezra Merkin involves Merkin's "masterful marketing" of three investment vehicles: the Ascot, Gabriel and Ariel funds.[17] The funds' offering documents and quarterly financial statements to investors allegedly hid Madoff's involvement from most of the funds' investors and instead falsely conveyed that Merkin personally managed the funds' day-to-day operations. Merkin received $35 million in annual management fees, despite the fact that Madoff managed virtually all the investments for the three funds.

In his April 2009 Complaint against Merkin, Attorney General Cuomo asserts various Martin Act and Executive Law § 63(12) claims stemming from alleged misrepresentations, omissions and attempts to conceal material information by Merkin during conversations with investors and in offering materials provided in connection with the marketing and sale of the investment funds managed by Merkin. Attorney General Cuomo alleges that Merkin made false and misleading statements regarding the due diligence he would conduct (an allegation substantially similar to that made by South Cherry in *Hennessee*). Attorney General Cuomo also alleges that Merkin breached his fiduciary duty to investors by failing to conduct adequate due diligence and failing to make diligent inquiry into the operations and risks of investing in Madoff, and a reckless disregard of numerous seemingly obvious warning signs that Madoff could be engaged in fraud.

Attorney General Cuomo noted a number of warning signs known to Merkin regarding Madoff's investment process, performance, disclosure (or lack thereof), operations and use of service providers that should have sounded alarms, especially given Merkin's education, investment experience and very specific concerns expressed to Merkin by trusted associates and industry professionals. They include:

- Madoff reported trades using paper trade confirmations without providing any form of electronic real-time access, despite the fact that Madoff's firm pioneered electronic screen trading in the 1970s;
- Madoff's family members occupied the most senior positions in the firm, including general counsel, chief compliance officer, and director of trading;

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- Madoff maintained strict secrecy about his management of investments and converted portfolio holdings to Treasury securities at quarter end, a practice that in light of Madoff's strategy served no business purpose other than to reduce transparency (and arguably likely hurt performance as well);
- Madoff's long-term returns were unusually stable, contrary to repeated warnings from others regarding the inconsistency between Madoff's low volatility and high returns and inability of other sophisticated investors to replicate returns using similar investment strategies;
- Merkin knew or "was reckless in not knowing" that Madoff's accounting firm was an unknown operation with two professionals operating in a small strip mall office, rather than a recognized audit firm;
- Madoff "self-cleared" all securities trades (*e.g.*, initiated and executed trades, and maintained custody of the securities), a failure to segregate responsibilities that "increased the risk of fraud."

Despite such warning signs, Merkin ostensibly conducted no due diligence beyond talking to Madoff by phone and reviewed trade confirmations and monthly statements created by Madoff's firm itself. Also notable was the absence of reasonable answers to such concerns.

MERKIN'S BREACH OF TRUST TO NONPROFITS

By 2008, Merkin managed $215 million in charitable assets of 35 nonprofit organizations. Nearly $115 million of the non-profit investments represented investments by organizations of which Merkin was a director, trustee, adviser to or member of the boards' investment committee. Attorney General Cuomo, who is responsible for overseeing the administration of over 60,000 non-profit organizations in New York State, is broadly empowered to civilly prosecute fiduciaries like Merkin who financially benefit from their positions of trust pursuant to New York's Not-for-Profit Corporation Law (the "N-PCL").

Pursuant to his authority under the N-PCL, Attorney General Cuomo alleges that Merkin "failed to discharge his fiduciary duties as an officer and director of "Merkin Affiliated" non-profits" in violation of the N-PCL.

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Specifically, it is alleged that Merkin violated Section 112 of the N-PCL, which enables the Attorney General to investigate and civilly prosecute officers and directors of non-profit organizations; Section 717 of the N-PCL, which imposes on officers and directors the fiduciary duties of care, loyalty and obedience and Section 720, which provides for an action by the Attorney General to compel an officer or director to account for breach of his fiduciary duties or to enjoin or set aside an "unlawful conveyance, assignment or transfer of corporate assets."

The N-PCL claims are based on Merkin's collecting management fees when in fact he failed to disclose that Madoff, and not Merkin, was managing the funds and failing to disclose conflicts of interests when Merkin recommended funds in which he had a financial interest. The breach of fiduciary duty claims are also based on his failure to make diligent inquiry into the risks of investing with Madoff, and ignoring numerous indications that Madoff was engaging in fraud.

THE LESSONS

For investment advisers, consultants and feeder fund managers, the *Hennessee* case and Merkin complaint reveal several red flags and "obvious signs" that should trigger closer attention and follow-up inquiries and certain basic minimum levels of due diligence that should be conducted when recommending or making discretionary allocations to third-party investment managers. The Merkin case also offers practical tips for the investment fiduciary when reviewing investment managers and portfolio performance. Practical considerations include:

- Make sure your investment committee or finance committee have members with the appropriate level of expertise to understand financial, operational and regulatory issues, among other things.
- Review and update your organization's investment policy to readjust to changing market conditions.
- Review the organizations' investment portfolio and adjust accordingly. It is important to be aware of the portfolio's investments and understand the opportunities and risks related to such investments.

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- Take a hard look at your investment manager or adviser. Are they transparent? Can they explain in plain English why they chose a certain investment strategy for the organization? Will they answer specific questions about investments — winners or losers? Are the investments in line with the goals and objectives outlined in the organization's investment policy?
- Are the promised investment returns too good to be true? Are investment returns, volatility, and performance attribution consistent or generally in line with those generated by other manager's utilizing the same or similar investment strategy? If others cannot achieve similar returns with similar investment strategies, are their explanations reasonable or do they generally seem to be evasive?
- Investigate whether underlying investment managers are registered with the Securities and Exchange Commission or otherwise conduct themselves as if they were registered. Periodically review the managers' policies and procedures, including compliance policies and Code of Ethics.
- Investigate your investment manager's auditors and other service providers. Are they known by others? What is the size of the operation?
- Be proactive in the search for conflicts of interests. Evaluate how they are identified and how quickly they are resolved. Are they prevalent? Does the manager utilize affiliated broker-dealers, engage in principal trading or other related-party arrangements, permit personal trading or have side-by-side trading considerations that might impact allocations and other portfolio decisions? To what extent are conflicts disclosed in the manager's Form ADV (if registered with the SEC) and, if applicable, fund offering documents?
- Make sure to document your discussions with investment managers. Memorialize steps taken by the investment committee in making its selections and any material issues that arise during your due diligence.
- Periodically review your investment process in an effort to identify factors and other considerations that might improve your overall due diligence.

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This past year has shown that fiduciaries cannot take a passive approach to their investment policies. The belief that one could simply turn over money to a financial wizard and bank steady returns in many instances turned out to be pure fantasy. Investment fiduciaries now must constantly examine the details and wisdom of any investment. The place to start is at the beginning, with an in-depth review of the due diligence policies that are at the heart of the firm's strategy. An organization's due diligence policy may once have been an afterthought; now it must be the vanguard of a protective strategy to ensure that investors do not fall prey to the next Ponzi scheme.

NOTES

[1] 07-CV-3658, 2009 U.S. App. LEXIS 15467 (2d Cir. July 14, 2009).
[2] *Id.* at *36-37 quoting *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 48 (2d Cir. 1978).
[3] South Cherry's breach of contract claim was dismissed because Hennessee's representations concerning its due diligence process were not in writing as required by New York's Statute of Frauds.
[4] South Cherry did not appeal the district court's dismissal of breach of fiduciary claim.
[5] *Id.* at *26 (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 318-321 (2007) (defining scienter as "a mental state embracing intent to deceive, manipulate or defraud.")) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)).
[6] *Id.* at *38.
[7] *Id.* at *38-39.
[8] *Id.* at *29 (quoting *Novak v.Kasaks,* 216 F.3d 300, 312 (2d. Cir. 2000)).
[9] *Id.* at 29-30 (citing *In re Carter-Wallace, Inc. Securities Litigation*, 220 F.3d 36, 39 (2d Cir. 2000)) (quoting *Rolf*, 570 F.2d at 47).
[10] The pleading standard for conscious recklessness was met where plaintiff alleged the defendants made statements that sales to China would be "an important new source of revenue" when they knew or should have known that Chinese import restrictions would severely limits such sales. *Cosmas v. Hassett*, 886 F.2d 8, 12 (2d Cir. 1989). Similarly, conscious recklessness was successfully plead when plaintiff released to the investing public several

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highly positive predictions about the marketing prospects of a computer system when plaintiff knew or shall have known several facts about the system and its consumers that revealed "grave uncertainties and problems" concerning future sales of the system. *Goldman v. Belden*, 754 F.2d 1059, 1069-70 (2d Cir. 1985).

[11] Among other things, Hennessee's marketing materials touted its "proprietary database and analytics" and five phase "unique" due diligence process. Hennessee represented that it would only consider hedge funds with "3 years audited track record" and that its due diligence included an "assessment of the fund's 'experience,' 'credibility,' and 'transparency,'" studies of individual securities positions, a review of audited financial statements and measures to verify the auditor, background checks on key personnel and confirmation of the fund's prime brokerage relationship. Hennessee's pitch book also emphasized its "ongoing and continuous quantitative and qualitative analysis" and "ongoing due diligence."

[12] *South Cherry Street LLC,* 07-CV-3658, 2009 U.S. App. LEXIS 15467, at *42.

[13] New York General Business Law ("GBL") Section 352 *et. seq.* (the "Martin Act").

[14] GBL 352-c(1)(c).

[15] Like Section 206(2), the Martin Act does not provide the individual investor with a private right of action.

[16] Pursuant to Executive Law 63(12) the Attorney General is authorized to bring an action for restitution, damages, and other relief in connection with repeated fraudulent or illegal acts in the carrying on of any business.

[17] *Cuomo v. J. Ezra Merkin*, No. 450879-2009 (Sup. Ct. N.Y. County, filed April 6, 2009).

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