

KLS — Kachroo Legal Services, P.C.

Background

A federal court in New York recently ruled that the Fairfield Greenwich Group (“FGG”)—one of the “feeder funds” responsible for funneling money into Madoff’s fraudulent investment scheme—must face claims by defrauded investors.¹

According to the complaint filed in the matter, FGG and its administrators, custodians and auditors violated federal securities law and committed state law violations (such as fraud, gross negligence and breach of fiduciary duties) by investing plaintiffs’ money in Madoff’s Ponzi scheme. Earlier this year, the FGG defendants filed a motion to dismiss the complaint. That motion was denied in substantial part on August 18, 2010, allowing the case against FGG to move forward (referred to herein as the “Fairfield Decision”).

“Scienter”

To state a claim for violation of federal securities laws, plaintiffs face the hurdle of demonstrating that the defendants were not just careless or negligent, but that they acted with scienter, “a mental state embracing intent to deceive, manipulate or defraud.” In the Fairfield Decision, the court found that the plaintiffs satisfied this burden, where they presented evidence that FGG and its officers: (i) benefitted in a concrete and personal way from Madoff’s fraud;² (ii) engaged in illegal behavior by “stymieing” the SEC’s investigation into Madoff’s trading activities; (iii) had access to information “that contradicted their public statements” and (iv) “failed to check information they had a duty to monitor.” Key to the court’s decision was the fact that defendants ignored a number of “red flags” surrounding Madoff’s operations, including:

- General secrecy and refusal to answer even basic questions.
- Positioning of family members in key positions at Madoff’s firm.
- Failure to trade through an independent broker.
- Acting as custodian or sub-custodian for the FGG’s assets.
- Using paper trading records, provided to FGG 3-5 *days* after the purported trades.
- Employing an extremely under-sized accounting firm.
- Claiming unerring profits.
- Reporting trades at prices outside the stocks’ actual trading ranges.
- Reporting trades that supposedly took place on weekends.

¹ Plaintiffs have asserted claims on their own behalf and on behalf of all similarly situated investors. The case is therefore considered a “putative class action,” but will have to undergo the class certification process before being designated as a class action.

² General profit-making motive is insufficient, on its own, to prove fraudulent intent but, according to the court, provides “important background information in analyzing scienter.” *Anwar v. Fairfield Greenwich, Ltd.*, 2010 U.S. Dist. LEXIS 86716, *77 (S.D.N.Y.)

The Fairfield Decision is of particular interest, given the prior federal court ruling in *South Cherry St. v. Hennessee Grp.*, 573 F.3d 98 (2d Cir. 2009). In the *South Cherry* case (as in the Fairfield case), investors brought suit against a financial advisory group for recommending a hedge fund that ultimately turned out to be a Ponzi scheme. The court in *South Cherry* concluded that the plaintiffs had not demonstrated that the defendants acted with scienter, where the evidence indicated that the defendants' statements may have been due to (merely) careless mistakes.

In contrast, the Fairfield plaintiffs adequately alleged scienter where they claimed that the FGG defendants "ignored . . . what was handed to them" and that the information given to defendants "was readily suspicious to any reasonable person exercising ordinary prudence."³

State Law Claims

Also of note, the court held that the plaintiffs retained their state law rights, a potential issue that stems from the enactment of the Securities Litigation Uniform Standards Act ("SLUSA") in 1998. SLUSA prohibits plaintiffs from bringing any case that: (i) purports to be a class action, (ii) on behalf of fifty or more members, (iii) for violations of state law, (iv) "in connection with the purchase or sale" of securities. The purpose behind SLUSA was to prevent plaintiffs from circumventing the stringent pleading requirements of federal law by bringing state-law based class actions.

In the Fairfield Decision, the court concluded that "[i]nvestments in the Funds simply were not purchases of covered securities" as defined in SLUSA, thus allowing the plaintiffs to proceed with their state law claims.⁴

Pursuing Your Rights as an Investor

The Fairfield Decision offers key insights for future litigation against banking entities that recommended investments in "feeder-funds" like FGG. To succeed, plaintiffs will be required to prove more than just that the banking entity *could* have discovered the fraud *if* it had engaged in certain due diligence. Rather, to survive, plaintiffs will need to demonstrate that the banking entity ignored red flags (such as those discussed above) and/or that those red flags that they had in their possession were "readily suspicious."

KLS is investigating claims against American Express International and its successor, Standard Chartered, and plans to file suit in the coming months. If you invested in Amex prior to 2008 and lost part or all of your investment due to Madoff's fraudulent investment scheme, please contact our offices immediately to learn how you can join the litigation.]

³ *Id.* at *88.

⁴ SLUSA defines "covered security" in a slightly different manner than the term is defined for purposes of alleging a securities fraud claim under the Securities Exchange Act of 1934.