SECOND CIRCUIT AFFIRMS DISMISSAL OF SECURITIES FRAUD CLAIMS AGAINST INVESTMENT ADVISER THAT FAILED TO DETECT A PONZI SCHEME

In *South Cherry Street, LLC v. Hennessee Group LLC*, No. 07-3658-cv, 2009 WL 2032133 (2d Cir. July 14, 2009), the United States Court of Appeals for the Second Circuit affirmed a lower court's ruling that an investment adviser was not liable for securities fraud for failing to uncover a Ponzi scheme. In doing so, the Second Circuit held that allegations that the investment adviser failed to perform due diligence and, had it done so, would have uncovered the fraud were insufficient to satisfy the heightened pleading standard for scienter. The Second Circuit's holding could be helpful to feeder funds that invested money in the infamous Madoff Ponzi scheme, many of which are now facing a barrage of investor lawsuits.

Background

The *South Cherry* case arose from a massive fraud associated with a family of funds known as the Bayou Group. Bayou Group's principals, Samuel Israel III and Daniel E. Marino, operated Bayou Group as a fraudulent Ponzi scheme and, by August 2005, Bayou Group had collapsed. Later in 2005, Israel and Marino both pled guilty to defrauding investors. Between March 2003 and October 2004, plaintiff South Cherry invested $1.15 million in one of Bayou Group's affiliates — Bayou Accredited — allegedly on the recommendation of Hennessee Group, an investment adviser specializing in hedge funds.

According to the complaint, South Cherry and Hennessee Group entered into an oral agreement pursuant to which Hennessee Group agreed to conduct a rigorous due diligence review of hedge funds and to recommend appropriate funds to South Cherry for investment purposes. In exchange, South Cherry agreed to pay Hennessee Group an annual commission of one percent of each hedge fund investment South Cherry made based on Hennessee Group's recommendation. South Cherry further alleged that, in deciding to invest in Bayou Accredited, it relied on Hennessee Group's representation that it had conducted a rigorous due diligence review of the fund, including "an assessment of the fund's 'Experience,' 'Credibility,' and 'Transparency'" and measures to verify the fund's auditor.

As it turned out, the Bayou Group was a sham, and the background facts about its principals and its auditor that were provided to Hennessee Group were utter fabrications. Approximately eight months after the fraud was exposed, South Cherry commenced a lawsuit alleging that Hennessee Group committed securities fraud and breached its contract with South Cherry by failing to perform adequate due diligence on Bayou Accredited. The district court dismissed South Cherry's securities fraud claims for failure to plead scienter and dismissed the breach of contract claim on the basis of the statute of frauds.

Decision

The Second Circuit affirmed the district court's decision. In doing so, the circuit court noted that the complaint was devoid of any allegation that Hennessee Group "had knowledge that any representation it made as to the records or circumstances of Bayou Accredited . . . was untrue." And the Second Circuit found the complaint's allegations — namely, that Hennessee Group "would" have uncovered the Ponzi scheme had it performed the rigorous due diligence that it promised — were insufficient to allege scienter. The circuit court also dismissed South Cherry's allegation that Hennessee Group had ignored "red flags" that should have tipped it off to the fraud, finding that the complaint did not allege any fact known to Hennessee Group at the time it recommended Bayou Accredited that either made the falsity of any of Bayou's representations "obvious" or should have alerted Hennessee Group that Bayou's claims were dubious.

The circuit court specifically rejected as a predicate for a fraud claim plaintiff's contention that, had Hennessee Group verified Bayou Accredited's auditor, as it promised to do, it would have discovered that the auditor was not independent and was actually owned by one of Bayou Group's principals. And the court deemed that the complaint's central fraud theory — that Hennessee Group defrauded plaintiff by representing that it had performed due diligence when in fact it had not — was "hardly a cogent or compelling suggestion," in that it was not "plausible to infer that an industry leader that prides itself on having expertise . . . , that emphasizes its thorough due diligence process, [and] that values and advertises its credibility in the industry . . . would deliberately jeopardize its standing and reliability, and the viability of its business, by recommending to a large segment of its clientele a fund as to which it has made, according to South Cherry, little or no inquiry at all."

The Second Circuit also affirmed the dismissal of the breach of contract claim, holding that the alleged oral agreement between South Cherry and Hennessee Group violated New York's statute of frauds because the agreement, by its terms, did not contemplate complete performance within one year of its making.

The Second Circuit's decision should be contrasted with the Securities and Exchange Commission's settlement with Hennessee Group and its managing principal, Charles J. Gradante, which arose out of the same set of facts underlying the *South Cherry* case. Hennessee Group and Gradante agreed to pay a fine and disgorge fees to settle the SEC's charges that they did not conduct the due diligence they promised and disregarded certain "red flags" during their diligence review and subsequent monitoring of Bayou. According to the SEC, their conduct operated as a fraud on Hennessee Group's clients in violation of Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"). Because Section 206(2) does not require proof of fraudulent intent, the SEC's settled findings are not necessarily inconsistent with the Second Circuit's decision.

Conclusion

The Second Circuit's decision will undoubtedly be helpful to feeder funds that face securities fraud claims arising out of their Madoff investments. In particular, in the wake of this decision,

plaintiffs seeking to allege securities fraud against such funds based solely on a theory that the funds misrepresented the quality of their due diligence will face an uphill battle, unless they are able to make a much stronger factual case for recklessness or actual knowledge on the part of the feeder funds than South Cherry was able to do. Feeder funds themselves may still face a challenge from the SEC, which has at its disposal Section 206(2) of the Advisers Act, which does not require proof of fraudulent intent but has no private right of action.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact James C. Dugan (212-728-8654, jdugan@willkie.com), Barry P. Barbash (202-303-1201, bbarbash@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

August 4, 2009

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.