Wexler v KPMG LLP
2014 NY Slip Op 30825(U)
April 1, 2014
Supreme Court, New York County
Docket Number: 101615/09
Judge: Richard B. Lowe III

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 56

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JAY WEXLER, individually and derivatively on behalf of Rye Select Broad Market Prime Fund, L.P.,

Plaintiff,

Index No. 101615/09

-against-

KPMG LLP; KPMG UK; KPMG INTERNATIONAL; JP MORGAN CHASE & CO.; THE BANK OF NEW YORK MELLON; TREMONT PARTNERS, INC.; TREMONT GROUP HOLDINGS, INC.; TREMONT CAPITAL MANAGEMENT, INC.; OPPENHEIMER ACQUISITION CORPORATION; MASSACHUSETTS MUTUAL LIFE INSURANCE; SANDRA L. MANZKE; ROBERT I. SCHULMAN; PAUL KONIGSBERG; ANNETTE BONGIORNO; FRANK DIPASCALI; ANDREW MADOFF; MARK MADOFF; PETER MADOFF; and JOHN DOES 1 THROUGH 30,

Defendants,

Rye Select Broad Market Prime Fund L.P.,

Nominal Defendant.

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RICHARD B. LOWE, III, J:

The following defendants' motions to dismiss are consolidated for disposition: Massachusetts Mutual Life Insurance Company (Mass Mutual), under motion sequence number 022; Oppenheimer Acquisition Corp. (Oppenheimer), under motion sequence number 030; Rye Select Broad Market Prime Fund, L.P. (Rye Select Fund), under motion sequence number 032; Sandra Manzke (Manzke), under motion sequence number 033; and Tremont Partners, Inc. (Tremont Partners), Tremont Group Holdings, Inc. (Tremont Group), Tremont Capital Management, Inc. (Tremont Capital) (together, Tremont), and Robert Schulman (Schulman),

under motion sequence number 034.

This action involves the notorious Ponzi scheme of Bernard Madoff (Madoff) through his investment company, Bernard L. Madoff Investment Securities LLC (BMIS). The 10-count, 263-page amended complaint asserts the following direct and derivative causes of action: fraud; aiding and abetting fraud; breach of fiduciary duty; aiding and abetting breach of fiduciary duty; professional negligence; fraudulent inducement; aiding and abetting fraudulent inducement; negligent misrepresentation; conversion; and unjust enrichment.

I. Factual Allegations[1]

Tremont Capital is the "flagship fund of the hedge fund division of the Tremont Group organization" (Amended Complaint, ¶ 40), and the predecessor to Tremont Group (*id.*, ¶ 50), an entity owned by Oppenheimer. *Id.*, ¶ 40. Oppenheimer, in turn, is owned by Massachusetts Mutual. *Id.*, ¶ 47. Tremont Capital owns Tremont Partners, the general partner of the Rye Select Fund. *Id.*, ¶¶ 39-40. Schulman was at times Tremont Group's president, chief operating officer (COO), and chief executive officer (CEO). *Id.*, ¶ 52. Manzke was allegedly Tremont Capital's founder and co-CEO with Schulman. *Id.*, ¶ 50.

Plaintiff Jay Wexler (Wexler) is a limited partner of the Rye Select Fund (*id.*, ¶ 33), in which he claims to have invested $275,000 in January 2007 (*id.*, ¶¶ 246, 349), with subsequent

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[1] The facts surrounding Madoff's Ponzi scheme are now well-known and comprehensively outlined in various judicial opinions. *See e.g. In re Tremont Sec. Law, State Law, & Ins. Litig. v Rye Select Broad Market XL Fund*, 703 F Supp 2d 362 (SD NY 2010); 2013 WL 4730263, 2013 US Dist LEXIS 125550 (SD NY, Sept. 3, 2013); 2013 WL 5393885, 2013 US Dist LEXIS 138616 (SD NY Sept. 26, 2013); and 542 Fed Appx 43 (2d Cir 2013); *see also Securities Inv. Protection Corp. v Bernard L. Madoff Inv. Sec. LLC*, 443 BR 295 (SD NY 2011), *affd* 512 Fed Appx 18 (2d Cir 2013); *Securities Inv. Protection Corp. v Bernard L. Madoff Inv. Sec. LLC*, 424 BR 122 (SD NY 2010).

investments and earnings bringing his account valuation to $431,679 by October 2008. *Id.*, ¶ 354. Wexler's investment was allegedly lost when the Rye Select Fund invested his funds with BMIS and, as a result, with Madoff's Ponzi scheme.

The amended complaint alleges that Tremont was BMIS's second-largest investor (Amended Complaint, ¶ 13), as Tremont invested $3.3 billion (more than 50 percent of its funds) with Madoff and the "Rye Select Funds had approximately $2.37 billion invested with Madoff and BMIS" (*id.*, ¶¶ 42, 122 [l], 190), but for 13 years Tremont's purported due diligence efforts failed to detect that the investment manager, Madoff, "had never bought or sold a single security." *Id.*, ¶ 389. Wexler avers that, in fact, Tremont never conducted any due diligence and never confirmed or verified any of BMIS's actual trading; instead, Tremont accepted Madoff's general statements about his investment strategy – the purported "split strike conversion" – and failed to discover Madoff's fraud. *Id.*, ¶ 13, 37, 145, 147-148.

BMIS created and sent investors statements with trade confirmations, but in reality, the trading never occurred. *Id.*, ¶ 150. Wexler alleges that "[n]ot one single trade was made for at least thirteen years" (*id.*), even though BMIS moved up to $13 billion in and out of the market each month, with less than 25 employees. *Id.*, ¶ 153. The amended complaint identifies 20 "red flags" that allegedly "would not have been overlooked by the sophisticated money managers who steered their clients in Madoff's direction or by the companies that made the fraud succeed" (*id.*, ¶ 173), as follows:

(1) no one was ever able to replicate Madoff's purported "split strike conversion" strategy (*id.*, ¶ 173 [a]);

(2) "Madoff claimed to invest in stocks that mimicked the S&P 100," while "his own

returns frequently deviated from that index," generally performing well even in declining and depressed markets (*id.*, ¶ 173 [b]);

(3) Friehling & Horowitz, the firm that audited BMIS, had only three employees operating out of a small office, and it took the United States Securities and Exchange Commission (SEC) only a few hours to determine that no audit work had ever been performed; the firm also prepared BMIS's financial statements, thereby placing Friehling & Horowitz "in the impossible role of auditing the financial statements it prepared"; and Friehling and/or his wife invested millions of dollars with BMIS, thereby failing to maintain independence as an auditor (*id.*, ¶ 173 [c]);

(4) Madoff's family members controlled most of the key positions at BMIS (*id.*, ¶ 173 [d]);

(5) Madoff was investment advisor, custodian, and administrator of the investment funds, creating a conflict of interest that called for increased due diligence, such as contacting counterparties to verify trades and the existence of transactions and investments (*id.*, 173 [e]);

(6) "A custodian led the SEC to say 'a simple inquiry [in]to one of several third parties could have immediately revealed the fact that Madoff was not trading in the volume he was claiming,'" as there were discrepancies between the amounts allegedly held by feeder funds and amounts actually in Madoff's account with the Depository Trust Corporation, and contact with the purported custodian of the funds would have "unmasked Madoff's operation" (*id.*, ¶ 173 [f]);

(7) the feeder funds never received proxy materials from Madoff for the stocks he supposedly held (*id.*, ¶ 173 [g]);

(8) "Sometimes Madoff had to show records to regulators and auditors that were

supposed to include the names of the other parties to his trades," especially for options, "because Madoff sometimes claimed he traded directly with counterparties in the over the counter market rather than on an established exchange," but because no stocks or options were actually traded, contact with the purported counterparties would have revealed the fraud (*id.*, ¶ 173 [h]);

(9) Madoff allegedly demanded that some feeder funds not disclose that Madoff was making the investment decisions, and certain funds went along with this practice knowing it was not true (*id.*, ¶ 173 [i]);

(10) Madoff allegedly allowed investors to think he operated a hedge fund, even though he did not require any of the paperwork that most hedge funds require, such as certification that the investor meets SEC requirements for particular investments or materials showing the investor's relationship with the hedge fund (*id.*, ¶ 173 [j]);

(11) Madoff had a conflict of interest as both a registered securities broker-dealer and investor (*id.*, ¶ 173 [k]);

(12) BMIS took no fee for its money management services, instead purporting to earn a small trading commission of 4 cents on every share traded and $1 for every option, while allowing the feeder funds to charge a fee of 1 to 2 percent of assets plus a 20 percent performance fee, thereby creating an incentive for feeder funds "to turn a blind eye to Madoff's refusal to allow due diligence" (*id.*, ¶ 173 [l]);

(13) until 2006, BMIS did not register as an investment advisor with the SEC, thereby avoiding fiduciary duties and annual filing requirements; but after registering with the SEC in 2008, BMIS filed a "Form ADV" stating that it had $17 billion under management in 23 investment accounts with fewer than 6 employees handling investment advisory functions, and

sent out statements to more than 4,900 active customer accounts with a purported value of $64.8 billion under management (*id.*, ¶ 173 [m]);

(14) Madoff's purported split strike conversion strategy, which was used for all of his investors, would have involved "trading huge blocks of stocks at the same time, representing unrealistically high portions of the overall trading volume on the New York Stock Exchange for those securities on that day," making them "visible to the market" (*id.*, ¶ 173 [n]);

(15) "[e]xecution of the split strike conversion strategy for all of his accounts would have had to trade more options than existed" (*id.*, ¶ 173 [o]);

(16) "[i]t was not possible to find over-the-counter counterparties for his alleged option trading, because Madoff was always on the winning side of the trade," and counterparties had no incentive to "continuously take the other side of those trades because they would always lose money" (*id.*, ¶ 173 [p]);

(17) "[a] review of the Form 13F that institutional investment managers must file quarterly with the SEC to report their securities holdings regularly showed that the BMIS feeder funds held only a scattering of small positions in small, non S&P 100 equities. Madoff told clients that his strategy was to be 100% in cash or U.S. Treasuries at every quarter end, to avoid making information about the securities he was trading public," which "was inconsistent with his split strike strategy . . . . An auditor could have corroborated the existence of the U.S. Treasury Bills by asking to see independent confirmation of the book entries" (*id.*, ¶ 173 [q]);

(18) the feeder fund managers had no electronic access to their funds' accounts with Madoff, instead receiving paper tickets sent via U.S. mail, making it "impossible for feeder funds to monitor positions and risk profiles of their investments on a daily basis, as some claimed to do

for their investors" (*id.*, ¶ 173 [r]);

(19) large amounts of investor funds would sit, not invested, in BMIS's bank account at JP Morgan Chase & Co. (JP Morgan), and large amounts of cash were sent back and forth between London and New York, triggering signs of money laundering that banks are required to report (*id.*, ¶ 173 [s]); and

(20) Madoff transferred hundreds of millions of dollars to his London office, which wired the funds back to New York without buying any shares for investors, and the employees of the London office "never understood their job as investing in European securities, as Madoff claimed to be doing" (*id.*, ¶ 173 [t]).

According to the amended complaint, a chief executive of a large hedge fund institution stated that "'[t]here were a thousand red flags, if you did the work. It didn't take much energy to reverse engineer Madoff's track record and find that his split strike conversion method just would not have worked in certain markets the way he said it did.'" *Id.*, ¶ 174. Madoff's own employees also allegedly "had their doubts," reporting in *Fortune* magazine that "'[w]e knew it was statistically impossible' to have the steady gains." *Id.*, ¶ 175.

The feeder funds were allegedly "supposed to serve as trusted intermediaries between their clients and Madoff," monitoring each fund's performance to ensure that "hedge fund managers followed their stated strategy and allowed regular audits to ensure financial integrity, and make accurate and timely reports to investors." *Id.*, ¶ 177. The feeder funds allegedly had the ability "to bring many investors to a hedge fund," thereby creating "leverage to require much more disclosure than secretive hedge funds typically provided." *Id.* According to the amended complaint, the feeder funds had only one responsibility and duty, which was to "provide

oversight over the investment managers." *Id.*, ¶ 178. Wexler claims that Tremont relied on Madoff, "a single investment manger," and, therefore, Tremont "was under a high duty to ensure that this investment manager was actually trading securities, like it claimed." *Id.*, ¶ 389.

In an August 2008 press release, Tremont Capital's chief investment officer allegedly represented that "its Madoff feeder funds, mainly the Rye funds, brought Tremont investors 'the industry's most experienced and proven investment talent,'" and Tremont allegedly represented that it "had conducted a thorough due diligence of Madoff and BMIS . . . ." *Id.*, ¶ 189. Tremont allegedly "represented to investors that it conducted appropriate due diligence to investigate and monitor their investments and Tremont became an admitted fiduciary to its investors." *Id.*, ¶ 192. Tremont allegedly "knew that the reputation and performance of the outside Investment Advisor (BMIS) was important to its investors and represented that the advisor would be 'effectively selected.'" *Id.*

Tremont allegedly represented on its website that it "selects managers for our funds of hedge funds from the pool of available managers that have passed through our ***exhaustive multi-stage due diligence process***." Amended Complaint, ¶ 193 (emphasis in original). Tremont's "screen[ing]" process was allegedly "enabl[ed] . . . to capture both qualitative and performance-based quantitative information on hedge fund managers and to compare managers to their peer groups . . . ." *Id.* Tremont Capital's website allegedly stated that "[e]ffective investment strategies and oversight, thorough manager research, careful due diligence, advanced risk allocation and time-tested portfolio management form the cornerstone of a comprehensive platform that has been refined over a 23-year span of dedicated strides to maximize our clients' objectives." *Id.*, ¶ 179.

Tremont also allegedly represented in SEC filings that "it analyzes in detail all investment management organizations, including conducting on-site interviews to evaluate back office operations and internal staff as well as utilizing databases, wire services, performance measurement publications and other surveys." *Id.*, ¶ 195. These SEC filings were allegedly attached to the "Private Placement Memorandum" (PPM) sent to clients, including Wexler. *Id.*, ¶¶ 195, 343. In one SEC filing, Tremont Partners allegedly represented that it:

> "makes recommendations and/or selections of underlying investment managers for its clients and the making and recommendation of investments in private placement vehicles on behalf of such Clients of [Tremont Partners]. In doing so, [Tremont Partners'] research staff evaluates investment management organizations. The staff analyzes, in detail, the philosophy, styles, strategies, investment professionals, decision-making processes and performance of the organization and the investment products offered.
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> . . .
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> "[Tremont Partners] relies on underlying investment advisor reports and its examination of advisor operations as primary sources of information."

Id., ¶¶ 195, 350. In the PPM, Tremont allegedly represented that "it was guided in selecting a particular Investment Advisor based upon," among other things, the "'[c]ontinued favorable outlook for the strategy employed'" by the Investment Advisor. *Id.*, ¶ 347. Throughout the amended complaint, Wexler alleges that Tremont knew that Madoff would not allow due diligence to be performed on BMIS, which is one of the key reasons why his fraud was not discovered sooner. *Id.*, ¶¶ 37, 179, 180, 184, 191, 209-210, 214, 226, 383-384.

Wexler claims that several professionals in the financial industry recognized indications of Madoff's fraud. For instance, when Oppenheimer and Mass Mutual sought to acquire

Tremont in 2001, a competing purchaser allegedly retained Goldman Sachs to perform due diligence on BMIS during its valuation of Tremont. *Id.*, ¶¶ 209, 383. Goldman Sachs allegedly recommended that its client not purchase Tremont as a result of Madoff's lack of transparency and refusal to permit due diligence. *Id.*, ¶¶ 209, 383.

According to the amended complaint, "Rogercasey, an investment research and consulting firm, reviewed Tremont and warned [its] clients (but not the public) not to invest in Tremont because of 'concerns about the integrity of the Madoff structure.'" *Id.*, ¶ 191. Rogercasey allegedly reported in November 2002:

> "(Tremont's) largest exposure . . . is to Madoff . . . where Tremont receives limited independent third-party transparency . . . The only third-party, independent transparency that Madoff provides to its investors is being 100% in cash at the end of each year so that its auditor can verify with Madoff's banker that the cash is real. Madoff has no prime broker and no plan administrator. It acts as a broker/dealer, self clears and sends its own trade confirms to its investors all of whom have 'cash' accounts."

Id.

In 2003, Société Générale's investment bank allegedly performed due diligence on BMIS and "put BMIS on its internal blacklist after discovering so many indications of fraud." *Id.*, ¶ 397.

In 2007, Aksia LLC advised clients not to invest in BMIS, after performing due diligence and uncovering "extensive red flags." *Id.*, ¶ 399. In conducting due diligence, Aksia LLC allegedly "discovered that 'substantially all of the [feeder funds'] assets were custodied with Madoff Securities,' which 'necessitated' investigat[ing] BMIS' auditor, Friehling & Horowitz." *Id.* Aksia LLC allegedly "concluded that Friehling & Horowitz's operation, with only one active

accountant, 'appeared small given the scale and scope of Madoff's activities.'" *Id.* When Aksia LLC "conducted an onsite visit at BMIS and was shown the paper trade tickets mailed to the fund managers," it allegedly "concluded that 'Paper copies provide a hedge fund manager with the end of the day ability to manufacture trade tickets that confirm the investment results.'" *Id.*

In December 2008, *Pensions & Investments* allegedly reported that several banks and investment companies "refused to do business with Madoff or BMIS," including: JP Morgan; Bank of New York Mellon; Pacific Alternative Asset Management Co.; K2 Advisors LLC; Mesirow Advanced Strategies Inc.; Goldman Sachs Asset Management; UBS Global Asset Management; BlackRock Inc.; and Harris Alternatives. *Id.*, ¶ 398. According to the amended complaint, JP Morgan and Bank of New York Mellon continued to maintain BMIS bank accounts and administer accounts that they knew were fully invested in Madoff and BMIS. *Id.*

Harry Markopolos, a forensic accounting analyst, allegedly "tried to get the SEC to investigate Madoff in 2000, 2001, 2005, 2007, and 2008. *Id.*, ¶ 394. Markopolos allegedly "went to the SEC with an eight-page complaint questioning Madoff's returns, stating that they were unachievable using the trading strategy Madoff claimed to employ." *Id.* He questioned Madoff's "'perfect market-timing ability' and not[ed] that [Madoff] didn't allow outside performance audits." *Id.* Markopolos allegedly told Congress that "he suspected Madoff was a fraud within five minutes of seeing a brochure describing the split-strike conversion strategy because he could tell that, as described, it wasn't capable of getting anywhere near the returns advertised," and "[t]he biggest, most glaring tip-off was that Madoff only reported three down months out of 87 months, whereas the S&P 500 was down 28 months during that time." *Id.*, ¶ 395. Markopolos allegedly "examined the options side of Madoff's strategy and realized in

about 30 minutes that there weren't enough S&P 100 index options in existence for Madoff to do what he claimed to be doing." *Id.* Markopolos allegedly proved mathematically, in less than four hours, that Madoff was a fraud, and told Congress that, "'[a]t this point, I was incredulous as to how any fund would willingly invest in such an obvious fraud.'" *Id.*

Manzke founded Tremont Capital and was a sponsor and director of another Madoff "feeder fund," nonparty Kingate Global Fund. *Id.*, ¶ 50. Manzke was Tremont's initial CEO, and in 2000 became co-CEO with Schulman. She allegedly "developed a close relationship with Madoff" from the time she met him in the mid-1980s through her departure from Tremont in 2005, and continued to maintain that relationship thereafter, when she founded yet another Madoff feeder fund, nonparty Maxam Capital Management. *Id.* Manzke allegedly "claimed that she had extensive experience analyzing and conducting due diligence of investment managers such as Madoff and BMIS," and "knew that she and Tremont were making false and material misrepresentations by claiming that they did a thorough due diligence review of Madoff and BMIS." *Id.*, ¶ 51.

Schulman allegedly joined Tremont Group as president and COO in 1994, and was also a member of Tremont's audit committee. *Id.*, ¶ 52. In 2000, he became co-CEO with Manzke, and in 2005, when Manzke left Tremont, he became the sole CEO. *Id.* Schulman also allegedly had a "close relationship" with Madoff. *Id.* In 2007, Schulman left his position as CEO of Tremont to become president of "Rye Investment Management," another Tremont division that managed several "Rye funds that invested mainly with Madoff." *Id.*, ¶ 54. Schulman allegedly retired from Tremont in 2008, at which point he started another Madoff feeder fund, nonparty Foredestine LLC. *Id.* Schulman allegedly "met with Madoff at his offices regularly but never

pressed Madoff for real information," and "[w]hile Madoff explained the split strike conversion to [Schulman] in very broad terms, he refused to provide any specifics." *Id.*, ¶ 148.

According to the amended complaint, Manzke and Schulman both held prominent positions in the financial industry. *Id.*, ¶¶ 51, 55. They allegedly knew that neither they, nor Tremont, had ever carefully or thoroughly reviewed BMIS. *Id.*, ¶¶ 51, 55. Together, Manzke and Schulman allegedly fed Madoff and BMIS hundreds of millions of dollars, profiting handsomely while turning investor funds over to Madoff, without conducting any audit or due diligence of Madoff or BMIS. *Id.*, ¶¶ 51, 53. The amended complaint alleges that, three weeks before Madoff's confession, Manzke pulled $30 million of her own money out of BMIS. *Id.*, ¶ 367. In addition, Kingate Global Fund allegedly received $255 million from BMIS one month before Madoff's confession. *Id.*, ¶¶ 50, 369. Other "insiders" allegedly withdrew billions of dollars in the weeks immediately preceding Madoff's arrest. *Id.*, ¶¶ 369-373.

Against this backdrop of factual allegations, Wexler claims that he relied on the misrepresentations and omissions of the moving defendants. *Id.*, ¶¶ 177, 193, 196. Wexler also claims that, as Madoff's fraud was easily detected by other industry professionals, defendants herein should have known of the fraud and disclosed this knowledge to Wexler and the other limited partners of the Rye Select Fund. *Id.*, ¶ 400. Instead of detecting the fraud and reporting it, defendants allegedly "made affirmative misrepresentations about the success and safety of BMIS and the extent of their due diligence of BMIS (which was essentially non-existent)," and committed "acts of substantial assistance to make the fraud a success for so many years." *Id.*

II. Analysis

Tremont, Schulman, and Manzke moved to dismiss the amended complaint pursuant to

CPLR 3016 (b), 3211 (a) (1), and 3211 (a) (7). Oppenheimer moved to dismiss the amended complaint pursuant to CPLR 3013, 3016 (b), and 3211 (a). Mass Mutual moved to dismiss under CPLR 3211 (a) (7). The Rye Select Fund sought dismissal under CPLR 3211 (a) (2) and (a) (7).

While these motions were sub judice, the court in the federal action, *In re Tremont Sec. Law, State Law, and Ins. Litig. v Rye Select Broad Market XL Fund et al.* (Master File No. 08 Civ 11117) (Federal Action), approved a final settlement (Settlement) and issued a "Final Judgment and Order of Dismissal with Prejudice," dated August 19, 2011 (Final Judgment). Document number 348. As a result of the Final Judgment, the moving defendants supplemented their initial moving papers, submitting briefs arguing that the derivative claims asserted against them in the instant action should be dismissed on grounds of res judicata and release. As part of their res judicata argument, these defendants argue that two of Wexler's purported direct claims are actually derivative claims that belong to the Rye Select Fund, and that these two causes of action, along with Wexler's five other derivative claims, are barred by the Final Judgment.

A. Direct vs. Derivative Claims

Wexler asserts the following derivative causes of against, among others, the moving defendants: fraud (first cause of action); aiding and abetting fraud (second cause of action); breach of fiduciary duty (third cause of action); aiding and abetting Tremont's breach of fiduciary duty (fourth cause of action); and professional negligence (fifth cause of action). Wexler also purports to assert direct claims for conversion (ninth cause of action) and unjust enrichment (tenth cause of action).[2]

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[2] The moving defendants do not dispute that Wexler also asserts direct claims that are not barred by res judicata and release, but which they claim should nevertheless be dismissed for the reasons stated in their original motions to dismiss. These direct claims include fraudulent

Tremont and Schulman argue that Wexler's conversion and unjust enrichment causes of action are not direct claims, but rather, are based upon losses suffered by the Rye Select Fund, and that Wexler's injuries derive from his status as a limited partner. Oppenheimer and Mass Mutual raise the same argument in their separate motions. Oppenheimer opening brief at 17 n 6; Mass Mutual opening brief at 14. Manzke's motion to dismiss incorporates Tremont and Schulman's arguments by reference. Manzke opening brief at 1-2.

It is undisputed that the Rye Select Fund is a Delaware limited partnership. Vigna affirmation, exhibit B at vi. Therefore, Delaware law applies to plaintiffs' derivative claims, which implicate "the issue of corporate governance" and "the threshold demand issue." *Hart v General Motors Corp.*, 129 AD2d 179, 182 (1st Dept 1987); *see also* New York Partnership Law § 121-901 ("the laws of the jurisdiction under which a foreign limited partnership is organized govern its organization and internal affairs and the liability of its limited partners").

Under Delaware law, in order to determine whether plaintiff's claims are derivative or individual, the

> "court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation."

Tooley v Donaldson, Lufkin, & Jenrette, Inc., 845 A2d 1031, 1039 (Del 2004). The court must consider "(1) who suffered the alleged harm (the corporation or the suing stockholders,

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inducement (sixth cause of action), aiding and abetting fraudulent inducement (seventh cause of action), and negligent misrepresentation (eighth cause of action), and they are discussed below, in section II (C).

individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)." *Id.* at 1033; *Yudell v Gilbert*, 99 AD3d 108, 114 (1st Dept 2012) (adopting the *Tooley* test for distinguishing between direct and derivative claims).

Here, the conversion cause of action is based upon allegations that defendants controlled Wexler's money and spent it for their own purposes, disregarding Wexler's interests. Amended Complaint, ¶¶ 509-510. The unjust enrichment cause of action is based upon allegations that defendants received and benefitted from Wexler's money, and that they should be required to repay it. *Id.*, ¶¶ 514-516. In both causes of action, there is no direct injury to Wexler independent of injury to the Rye Select Fund. Rather, the injury is comprised of investment losses suffered by the Rye Select Fund, of which Wexler was a limited partner and investor. *Id.*, ¶¶ 19, 246, 349, 354. Thus, Wexler's alleged losses were suffered indirectly, as a result of investing in the Rye Select Fund, and, therefore, his causes of action for conversion and unjust enrichment are derivative claims that belong to Rye Select Fund. *See Feldman v Cutaia*, 951 A2d 727, 733 (Del 2008) ("[w]here all of a corporation's stockholders are harmed and would recover pro rata in proportion with their ownership of the corporation's stock solely because they are stockholders, then the claim is derivative in nature").

B. Res Judicata on Derivative Claims

The Federal Action was a class action arising out of Madoff's Ponzi scheme. The plaintiffs were investors in Tremont-managed hedge funds, including the Rye Select Fund. *See Elendow Fund, LLC v Rye Select Broad Market XL Fund*, 703 F Supp 2d 362 (SD NY 2010); *Elendow Fund, LLC*, 2013 WL 5179064, 2013 US Dist LEXIS 132114 (SD NY Sept. 16, 2013). The defendants in the Federal Action overlapped, in part, with defendants in the instant action,

including the moving defendants herein: Tremont, Rye Select Fund, Schulman, Manzke, Oppenheimer, and Mass Mutual.

Tremont and Schulman argue that the Settlement and Final Judgment in the Federal Action released all derivative claims against Tremont arising out of investments with Madoff. These defendants argue that Wexler's derivative claims belong to the Rye Select Fund, which has settled and released those claims, and that, therefore, Wexler's claims are barred by res judicata. Oppenheimer, Mass Mutual, and Manzke join and incorporate by reference the arguments of Tremont and Schulman.

> "[R]es judicata, or claim preclusion, bars successive litigation based upon the 'same transaction or series of connected transactions' if: (i) there is a judgment on the merits rendered by a court of competent jurisdiction, and (ii) the party against whom the doctrine is invoked was a party to the previous action, or in privity with a party who was."

Matter of People v Applied Card Sys., Inc., 11 NY3d 105, 122 (2008) (internal citations omitted).

Here, the parties do not dispute that the Federal Action and the instant action are based upon the same transactions and underlying factual allegations. Tremont, Schulman, Manzke, Oppenheimer, Mass Mutual, and the Rye Select Fund were all defined as "Settling Defendants" in the Final Judgment. Document number 348, ¶ 14. The Rye Select Fund was also defined as a "Settling Fund." Document number 350-1, ¶¶ 1.52 and 1.57. The Final Judgment defined "Released Claims" as "any and all direct, indirect and/or derivative claims, demands, rights, liabilities, causes of action, or lawsuits whatsoever . . . that could have been asserted in any forum by . . . any Settling Fund . . . against any of the Released Parties." Document number 348, ¶ 15. The Final Judgment provided that "[t]he actions and all Released Claims and Settling

Defendants' Claims are dismissed with prejudice" (*id.*, ¶ 13), and that "the Settling Funds . . . shall be permanently barred and enjoined from instituting, commencing, or continuing to maintain any such Released Claim against the Settling Defendants." *Id.*, ¶ 18. Wexler does not dispute that the Final Judgment constituted a judgment on the merits rendered by a court of competent jurisdiction. *Troy v Goord*, 300 AD2d 1086, 1086 (4th Dept 2002) ("order of dismissal in the federal action is entitled to res judicata effect where . . . the circumstances evince that it is on the merits or with prejudice to relitigation of the discontinued claim, or where the parties otherwise have indicated that the settlement and discontinuance would have such preclusive effect").

Wexler was not a party in the Federal Action, but it is undisputed that the Rye Select Fund was a defendant in the Federal Action, and that the plaintiffs in the Federal Action included limited partners of the Rye Select Fund. *See Elendow Fund, LLC*, 703 F Supp 2d at 366-367. The parties' dispute, therefore, focuses on whether Wexler was in privity with a party to the Federal Action. *Matter of People*, 11 NY3d at 122.

> "Because the claim asserted in a stockholder's derivative action is a claim belonging to and on behalf of the corporation, a judgment rendered in such an action brought on behalf of the corporation by one shareholder will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders."

Parkoff v General Tel. & Elecs. Corp., 53 NY2d 412, 420 (1981); *see also Auerbach v Bennett*, 47 NY2d 619, 627-268 (1979) ("a dismissal on the merits of one derivative action is generally a bar to suits by other stockholders of the same corporation on the same cause of action"). This general "rule is qualified by the condition that the judgment being raised as a bar not be the

product of collusion or other fraud on the nonparty shareholders," and also by the "condition that the shareholder sought to be bound by the outcome in the prior action not have been frustrated in an attempt to join or to intervene in the action that went to judgment." *Parkoff*, 53 NY2d at 420.

For example, *Levin v Kozlowski* involved a shareholder derivative action brought by two shareholders of Tyco International Ltd. (Tyco) in the New York Supreme Court. 13 Misc 3d 1236(A), *3, 2006 NY Slip Op 52142(U), *affd* 45 AD3d 387 (1st Dept 2007). Approximately six months later, the plaintiffs' counsel agreed to suspend the state court action pending the outcome of a "concurrent consolidated derivative action with a different named plaintiff" that was being prosecuted in federal court. 13 Misc 3d 1236(A) at *3. The federal action was "part of a wave of lawsuits," including dozens of class actions and three derivative actions. *Id.* The plaintiffs in the federal action filed a "Derivative Complaint," naming Tyco as a nominal defendant. *Id.* After several pleading amendments and motion practice, the federal court granted the defendants' motion to dismiss. *Id.* at *4.

Thereafter, when the plaintiffs sought to proceed with the action before the New York Supreme Court, the court acknowledged that "the particular Tyco shareholders named as plaintiffs in this suit are different from those in the Federal Action." *Id.* at 9. However, the court explained that "in derivative suits, shareholder plaintiffs are treated like equal and effectively interchangeable members of a class action because their claims belong to and are brought on behalf of the corporation, rather than on behalf of themselves," and that, therefore, "prior legal determinations in derivative suits can bind all other similarly situated plaintiffs who might bring subsequent derivative claims, thus avoiding wasteful and duplicative litigation." *Id.* at *9, citing *Parkoff*, 53 NY2d at 420. The court barred the plaintiffs' prosecution of the state court action,

holding that the derivative plaintiffs in the state court action were in privity with the Tyco shareholders in the federal action, and that both were derivative actions initiated on Tyco's behalf. *Id.* at *10.

Here, Wexler's derivative claims were represented in the Federal Action by other limited partners of the Rye Select Fund. These claims, and any damages awarded thereon, belong to the Rye Select Fund rather than the derivative plaintiffs. *Marx v Akers*, 88 NY2d 189, 193 (1996) (a derivative claim is one in which "'[t]he remedy sought is for wrong done to the corporation; the primary cause of action belongs to the corporation; [and] recovery must enure to the benefit of the corporation. The stockholder brings the action, in behalf of others similarly situated, to vindicate the corporate rights'"). Therefore, the Final Judgment in the Federal Action is binding on Wexler, barring his derivative claims in the instant action.

The court notes Wexler's contentions that he "was never included in the negotiation of the federal action settlement," and that he has "vigorously prosecuted his case" in the instant action. Wexler opp brief at 4; *see also id.* at 5 ("Wexler was knowingly excluded from settlement negotiations by Defendants"). Significantly, Wexler fails to make any showing that the Final Judgment was "the product of collusion or other fraud on the nonparty shareholders." *Parkoff*, 53 NY2d at 420. The Federal Action was commenced prior to the instant action. Wexler neither disputes that he was notified of the Settlement nor claims that he objected to the Settlement of the Federal Action.

Nor does Wexler claim that he was "frustrated in an attempt to join or to intervene in the action that went to judgment." *Id.* Rather, Wexler argues that "there [was] good reason for not intervening in the federal action," because another derivative plaintiff, the 2005 Tomchin Family

Charitable Trust, sought to intervene in the Federal Action but was denied. Wexler opp brief at 6-7. This argument is undermined by Tremont's submission of an order issued in the Federal Action, permitting the 2005 Tomchin Family Charitable Trust to intervene. Tremont reply brief, exhibit B.

The court further notes Wexler's heavy reliance upon *Breswick & Co. v Briggs* (135 F Supp 397 [SD NY 1955]), in support of his argument that it would be inequitable to allow defendants to use the Final Judgment to bind Wexler, because Wexler was not included in the settlement negotiations in the Federal Action. *Breswick & Co.* was a derivative action commenced by the stockholders of Alleghany Corporation against the company's officers and directors, for self-dealing and misappropriating business opportunities. This misconduct sparked "[n]umerous derivative actions" in 1954, including 10 consolidated actions in the New York courts and 10 consolidated actions in the Southern District. *Smith v Alleghany Corp.*, 394 F2d 381, 383 (2d Cir 1968). *Breswick & Co.* was not commenced until 1955. *Id.*

Four days after the court in a related case "granted a preliminary injunction and expressed conclusions of law substantially helpful to [the] plaintiffs[]," the parties to the state court litigation "announced a stipulation of settlement" that would terminate all derivative actions based upon the same corporate misconduct. *Breswick & Co.*, 135 F Supp at 403. The court in *Breswick & Co.* determined that the plaintiffs, "who perhaps had been the most vigorous and most successful in the litigation," were improperly excluded from settlement negotiations in the state court action, while the other derivative actions were consolidated and those parties participated in settlement negotiations by "designated . . . general counsel." *Id.* The court in *Breswick & Co.* enjoined the defendants "from interposing in this action any defense based upon

a judgment entered pursuant to an agreement not negotiated with plaintiffs or their counsel" (*id.* at 406), reasoning that the defendants were "not in equity entitled to utilize a judgment based upon a settlement negotiated behind the backs of the active plaintiffs here." *Id.* at 404.

In *Breswick & Co.*, however, the state court had not yet approved the settlement or issued a final judgment, whereas here the court in the Federal Action has already issued the Final Judgment. Moreover, here, the Federal Action was commenced prior to Wexler's state court action. As discussed above, Wexler neither disputes that he was notified of the Settlement nor claims that he objected to the Settlement of the Federal Action. Nor does Wexler identify any relevant procedural device potentially undermined by the Settlement, unlike the preliminary injunction issued just days before the settlement stipulation in *Breswick & Co.* Therefore, *Breswick & Co.* is distinguishable on its facts.

In short, none of Wexler's arguments warrant departure from the long-recognized "preclusive effect of judgments in derivative actions upon subsequent actions brought by stockholders who were not plaintiffs in the original action." *Levin*, 13 Misc 3d 1236(A) at *13 (internal quotation marks and citation omitted). As stated in *Levin*, "if this were not the rule, shareholder plaintiffs could indefinitely relitigate the demand futility question in an unlimited number of state and federal courts, a result the preclusion doctrine specifically is aimed at avoiding." *Id.* (internal quotation marks and citation omitted).

For the foregoing reasons, the motions of Tremont and Schulman, Oppenheimer, Mass Mutual, and Manzke to dismiss Wexler's derivative claims asserted against them in the first, second, third, fourth, fifth, ninth, and tenth causes of action, as barred by res judicata, are granted. Any derivative claims asserted against nominal defendant Rye Select Fund are likewise

dismissed as barred by res judicata.

C. Direct Claims

Tremont, Schulman, Manzke, Oppenheimer, and Mass Mutual do not dispute that Wexler's causes of action for fraudulent inducement, aiding and abetting fraudulent inducement, and negligent misrepresentation are properly asserted as direct claims. These defendants seek dismissal under CPLR 3211.[3]

1. Fraudulent Inducement (sixth cause of action)

The sixth cause of action for fraudulent inducement is asserted against Tremont only. Tremont argues that the pleading fails to identify a material misstatement upon which Wexler reasonably relied, or scienter.

In order to state a cause of action for fraudulent inducement, the pleading must allege "the representation of a material existing fact, falsity, scienter, deception and injury." *Century 21 v Woolworth Co.*, 181 AD2d 620, 625 (1st Dept 1992). Under CPLR 3016 (b), "the circumstances constituting the wrong shall be stated in detail," and "conclusory allegations" of fraud are insufficient. *Greschler v Greschler*, 51 NY2d 368, 375 (1980).

Here, the PPM does not identify any misstatement concerning Madoff's qualifications or his ability to invest the Rye Select Fund's assets. The PPM stated that, "[i]n selecting a particular Underlying Manager to which the Partnership will allocate assets and/or obtain exposure to the investment returns of," Tremont Partners, as general partner, was guided by the following criteria: "[t]he Underlying Manager's past performance and reputation"; "[s]ize and efficiency of assets managed"; "[c]ontinued favorable outlook for the strategy employed"; and

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[3] Manzke incorporates by reference the arguments made by Tremont and Schulman.

"[a]bility of the Partnership to make withdrawals or liquidate its investment." Vigna affirmation, exhibit B at 2. The amended complaint essentially concedes that Madoff satisfied this criteria, alleging that Madoff: "became a guru within the financial industry," serving as chairman of the board of directors of the NASDAQ (Amended Complaint, ¶ 78); managed over $17 billion in assets through BMIS (*id.*, ¶ 138); generated "unbelievably positive [returns] over time" (*id.*, ¶ 173 [b]); and permitted investors to withdraw billions of dollars (*id.*, ¶¶ 124-125, 129).

Moreover, Wexler fails to explain how representations concerning Tremont's due diligence obligations, as reported on Tremont's website and SEC filings, were false. Rather, the essence of Wexler's argument is based upon the speculative allegation that, "if Tremont had even done a small fraction of what it had claimed it was doing, Madoff's Ponzi scheme would have certainly been discovered." Wexler opp brief at 8. Although Wexler claims that Schulman and Manzke had close relationships with Madoff and met with him frequently (Amended Complaint, ¶¶ 50-52, 180), he fails to explain how Tremont, Schulman, or Manzke failed to comply with any due diligence requirements, rendering this allegation conclusory as a matter of law. *Greschler*, 51 NY2d at 375; *see also ECA & Local 134 IBEW Joint Pension Trust of Chicago v JP Morgan Chase Co.*, 553 F3d 187, 205-206 (2d Cir 2009) (alleged misrepresentations concerning JP Morgan's "'highly disciplined' risk management" processes were "no more than 'puffery'" that could not have misled a reasonable investor); *Shields v Citytrust Bancorp, Inc.*, 25 F3d 1124, 1129 (2d Cir 1994) ("reject[ing] the legitimacy of 'alleging fraud by hindsight'"); *In re Health Mgt. Sys., Inc. Sec. Litig.*, 1998 WL 283286, *5, 1998 US Dist LEXIS 8061, *12-13 (SD NY 1998) ("the conclusory allegation that the opposite of a statement in a press release is true, without further factual elaboration, is insufficient").

Nor does Wexler allege any misrepresentation concerning Tremont's disclosure of the risks associated with investing in the Rye Select Fund. Specifically, Rye Select Fund's Amended and Restated Limited Partnership Agreement (LP Agreement) gave Tremont Partners "the power . . . to carry out any and all of the objects and purposes of the Partnership," including "delegat[ing] such authority to Underlying Managers . . . to: (a) open, maintain and close accounts, including margin and custodial accounts, with brokers, which power shall include the authority to issue all instructions and authorizations to brokers regarding the Securities and/or money therein." Vigna affirmation, exhibit A, § 2.2.

In addition, the PPM provided that limited partnership interests in the Rye Select Fund were available "only to persons willing and able to bear the economic risks of this investment," which was identified as "speculative, illiquid and involv[ing] a high degree of risk." Vigna affirmation, exhibit B at ii, xv. The PPM disclosed that the Rye Select Fund "allocates its investment portfolio to one Manager selected by the General Partner." *Id.* at vii, 1, 12, 43. The PPM stated that "[t]here can be no guarantee of future performance and there is no assurance that the Partnership will be able to achieve its investment objective or be profitable." *Id.* at 3. The PPM warned that the investment was "suitable . . . only for sophisticated investors for whom an investment in the Partnership does not constitute a complete investment program and who fully understands, are willing to assume, and who have the financial resources necessary to withstand the risks involved . . . and to bear the potential loss of their entire investment in the Interests." *Id.* at 22; *see also* Subscription Agreement, Vigna affirmation, exhibit D at S-11, S-14 (Wexler certifying that he is an "accredited investor" because his net worth exceeded $5 million and annual income exceeded $200,000). The PPM outlined "risk factors," including: no assurances

that the Rye Select Fund would achieve its investment objective; the fund's lack of control over assets once allocated to the Underlying Manager; complete dependence upon the "Underlying" and "Designated Managers"; Tremont Partners' potential "lack of access to information" from the "Underlying Managers"; and concentration of "[a]ll or a substantial proportion of" the fund's assets with "a single prime broker." Vigna affirmation, exhibit B at 27-28. The PPM also disclosed the limited partners' lack of management and control of the Rye Select Fund. *Id.* at 36-37.

Wexler's account statements disclosed that his "investments have been and will continue to be custodied for the benefit of the portfolio at Bernard L. Madoff Investment Securities LLC" (Vigna affirmation, exhibit C), and the amended complaint concedes that "[f]or many average investors, the only way to invest in BMIS was through a feeder fund, like Tremont." Amended Complaint, ¶ 118. Significantly, the PPM expressly "invited" prospective investors "to review any materials available to the General Partner relating to: the Partnership; the operations of the Partnership; this offering; . . . the Disclosure Documents of the Underlying Managers; and any other matters relating to this offering." Vigna affirmation, exhibit B at 62. In other words, Wexler had access to the results of Tremont's due diligence inquiries. While none of these representations excuse Madoff's fraud, Wexler, a purported "sophisticated investor," fails to allege that he ever sought or was denied such information from Tremont, or that any such information contained misrepresentations. *Id.* at 22.

To the contrary, Wexler represented in his Subscription Agreement that he relied "solely" upon the PPM, the LP Agreement, and his "*own independent investigations*." Vigna affirmation, exhibit D at S-19 (emphasis added). He represented that he: "consulted with [his] own advisors,"

has "knowledge and experience in financial and business matters" and the ability to "evaluat[e] the merits and risks of [his] investment . . . and has obtained, in [his] judgment, sufficient information from the Partnership . . . to evaluate the merits and risks of such investment." *Id.*, exhibit D at S-19, S-21. These representations make clear that Wexler was aware of the risks of his investment and had access to any purported due diligence (or lack thereof) in Tremont's possession concerning the Rye Select Fund. For the foregoing reasons, Wexler has not alleged justifiable reliance on any false statements. *UST Private Equity Invs. Fund v Salomon Smith Barney*, 288 AD2d 87, 88-89 (1st Dept 2001) (no justifiable reliance where offering memorandum "specifically directed plaintiffs to 'rely upon their own examination' of [defendant] and to request from [defendant] whatever additional information or documents they deemed necessary to make an informed investment decision").

Nor has Wexler alleged scienter, as he fails to aver that "the misrepresentations were made with the intent to deceive." *Friedman v Anderson*, 23 AD3d 163, 167 (1st Dept 2005). Specifically, Wexler claims that Tremont benefitted from the purported fraud, earning up to $54 million annually from BMIS investments. Amended Complaint, ¶ 190. However, "the motive to earn fees alone is, without more, insufficient for the court to infer scienter under CPLR 3016 (b)." *Basis Pac-Rim Opportunity Fund (Master) v TCW Asset Mgt. Co.*, 40 Misc 3d 1240(A), *5, 2013 NY Slip Op 51494(U) (Sup Ct, NY County 2013); *SSR II, LLC v John Hancock Life Ins. Co. (U.S.A.)*, 37 Misc 3d 1204(A), *5, 2012 NY Slip Op 51880(U) (Sup Ct, NY County 2012); *see also Technical Support Servs., Inc. v International Bus. Machs. Corp.*, 18 Misc 3d 1106(A), *30, 2007 NY Slip Op 52428(U) (Sup Ct, Westchester County 2007); *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 289 F Supp 2d 416, 428 (SD NY 2003).

Wexler also claims that Tremont deliberately engaged in illegal behavior, knew facts and had access to information that would prove its statements false, and failed to properly monitor, ignoring the 20 "red flags" (discussed above) notwithstanding the due diligence requirements outlined in the PPM. Amended Complaint, ¶¶ 173, 403-407, 414, 477-481, 483-501.

> "To be sufficient, allegations of scienter based on red flags must include facts showing both that the defendant was actually aware of the alleged flags (*see South Cherry St., LLC v Hennessee Group LLC*, 573 F3d 98 [2d Cir 2009]; *Stephenson v Citco Group Ltd.*, 700 F Supp 2d 599, 622 [SD NY 2010]) and that the flags were 'so obvious[ly]' indicative of misconduct 'that the defendant must have been aware of [the wrongdoing]' and desirous of furthering it (*South Cherry St., LLC v Hennessee Group LLC*, 574 F3d at 109, 112; *see also MLSMK Inv. Co. v JP Morgan Chase & Co.*, 737 F Supp 2d 137, 144 [SD NY 2010] [finding allegations of scienter insufficient because '(w)hile it may be true that Defendants could have connected the dots to determine that Madoff was committing fraud, Plaintiff offers no facts to support the claim that they actually reached such a conclusion']).

Zutty v Rye Select Broad Mkt. Prime Fund, L.P., 33 Misc 3d 1226(A), *12, 2011 NY Slip Op 52121(U) (Sup Ct, NY County 2011).

As a preliminary matter, the amended complaint does not allege that the moving defendants actually knew about the purported red flags, but rather, it speculates that "the red flags here would have been obvious to anyone who performed serious due diligence." *Id.*, ¶ 173. For this reason alone, Wexler's claims concerning "red flags" fails to allege scienter. In any event, the amended complaint "fails to explain how one or more alleged red flags made it so obvious that Madoff was running a Ponzi scheme that defendants must have known about the scheme and wanted to further it." *Zutty*, 33 Misc 3d 1226(A), *13, citing *Laikin v Vaid*, 2001 WL 1682873, *2, 2001 NY Misc LEXIS 760, *3 (Sup Ct, NY County 2001) (dismissing fraud claim where

"the complaint does not allege specific facts as to how and when [the defendant] learned that the offering plan allegedly contained misleading information").

In support of his argument that the amended complaint alleges scienter, Wexler cites to *Anwar v Fairfield Greenwich, Ltd.* (728 F Supp 2d 372 [SD NY 2010]). In *Anwar*, the plaintiff adequately plead scienter, based upon allegations that, in addition to the alleged "red flags," two officers of the defendant Fairfield Greenwich entities "engaged in deliberately illegal behavior by attempting to stymie a[n SEC] investigation into Madoff's operation." *Id.* at 408. These individuals allegedly "had a conversation with Madoff before meeting . . . with the SEC, and . . . Madoff gave them what could charitably be called helpful hints in what to say to the SEC." *Id.* Madoff allegedly "began the phone call theatrically, noting ominously that 'this conversation never happened.'" *Id.* In addition, three officers "discovered that Madoff was using the curiously suspicious auditing firm [Friehling & Horowitz]," but one officer allegedly "authorized . . . employees to tell investors that the firm was 'a small to medium size financial services audit and tax firm' that had '100s of clients and [was] well respected in the local community.'" *Id.* at 409. Also, five officers allegedly "exchanged numerous emails noting . . . 'the gaps in [their] knowledge' about basic information of Madoff's operation." *Id.* Here, Wexler fails to allege analogous acts of misconduct, and, therefore, *Anwar* is distinguishable on its facts.

In short, "the failure to conduct due diligence or monitoring as promised, without more, does not support an inference that the defendants acted with scienter." *Prickett v New York Life Ins. Co.*, 896 F Supp 2d 236, 247 (SD NY 2012). As the court determined in the Federal Action:

> "[d]espite the complaint's extensive and detailed allegations regarding all the red flags that Tremont allegedly saw, the strongest inference to be drawn from them is that Tremont—like so many

> others—overlooked the red flags or rationalized them. Nowhere does the complaint specifically and plausibly allege that Tremont actually knew that Madoff's operation was a fraud."

Elendow Fund, LLC, 2013 WL 5179064 at *5, 2013 US Dist LEXIS 132114 at *24; *see also Prickett*, 896 F Supp 2d at 247 ("'the more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme and deceiving the SEC and other financial professionals'"). For the foregoing reasons, Wexler's sixth cause of action for fraudulent inducement is dismissed in its entirety.[4]

2. Aiding and Abetting Fraudulent Inducement (seventh cause of action)

The seventh cause of action for aiding and abetting Tremont's fraud is asserted against the following defendants: Oppenheimer; Mass Mutual; KPMG UK and KPMG International (together, KPMG)[5]; JP Morgan; The Bank of New York Mellon; and all individual defendants. The elements of aiding and abetting fraud are: "(1) the existence of an underlying fraud; (2) knowledge of this fraud on the part of the aider and abettor; and (3) substantial assistance by the aider and abettor in achievement of the fraud." *Stanfield Offshore Leveraged Assets, Ltd. v Metropolitan Life Ins. Co.*, 64 AD3d 472, 476 (1st Dept 2009) (internal quotation marks and citations omitted).

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[4] The court notes that, in various other actions, courts have held scienter lacking based upon the defendants' failure to deduce Madoff's Ponzi scheme. *See e.g. SSR II, LLC*, 37 Misc 3d 1204(A); *Zutty*, 33 Misc 3d 1226(A); *Stephenson*, 700 F Supp 2d 599; *MLSMK Inv. Co.*, 737 F Supp 2d 137; *Saltz v First Frontier, LP*, 782 F Supp 2d 61 (SD NY 2010), *affd* 485 Fed Appx 461 (2d Cir 2012); *S.E.C. v Cohmad Sec. Corp.*, 2010 WL 363844, 2010 US Dist LEXIS 8597 (SD NY 2010); *Meridian Horizon Fund, LP v Tremont Group Holdings, Inc.*, 747 F Supp 2d 406 (SD NY 2010).

[5] This cause of action was also asserted against KPMG LLP. However, by stipulation dated January 6 and 7, 2010, the parties voluntarily discontinued this action against KPMG LLP. Document number 146.

This cause of action is based entirely upon the named defendants aiding and abetting Tremont's alleged fraud. Amended Complaint, ¶¶ 483-501. As Wexler fails to allege an underlying fraud, he fails to satisfy the first element of his aiding and abetting claim. Accordingly, the seventh cause of action is dismissed in its entirety. *Stanfield Offshore Leveraged Assets, Ltd.*, 64 AD3d at 476.

This cause of action is dismissed against Manzke for the additional reason that, according to the amended complaint, Manzke left Tremont in 2005, but Wexler did not invest in the Rye Select Fund until 2007. Amended Complaint, ¶¶ 31, 50. Therefore, Manzke could not have "substantial[ly] assist[ed] . . . the fraud." *Stanfield Offshore Leveraged Assets, Ltd.*, 64 AD3d at 476 ("[s]ubstantial assistance" requires a showing that the "'defendant affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed,'" and that these actions "'proximately caused the harm on which the primary liability is predicated'").

3. Negligent Misrepresentation (eighth cause of action)

The eighth cause of action is asserted against Tremont and KPMG only.[6] This claim is based upon Tremont's alleged representations to limited partners, discussed above. Amended Complaint, ¶ 503. Tremont and KPMG allegedly owed duties to Wexler, as a limited partner of the Rye Select Fund, but "acted without any reasonable grounds for believing the representations were true, and intended by such representations to induce [Wexler's] reliance and investment in the Rye Select [Fund]." *Id.* Wexler claims that he relied on these representations in making his investment, and, as a result, suffered damages. *Id.*, ¶¶ 504-505.

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[6] The amended complaint alleges that KPMG UK audited Madoff's London business, and that KPMG LLP audited Tremont. Amended Complaint, ¶¶ 56-60. KPMG's motions to dismiss will be addressed in a separate opinion.

The elements of negligent misrepresentation are: "(1) the existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to the plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information." *J.A.O. Acquisition Corp. v Stavitsky*, 8 NY3d 144, 148 (2007).

As a preliminary matter, as discussed above in connection with Wexler's fraud claim, the amended complaint fails to allege reasonable reliance on Tremont's purported statements, or that the relied-upon statements were incorrect.

In any event, this cause of action fails against Tremont Partners, because it is barred by an exculpatory clause contained in section 2.7 of the LP Agreement. This clause provided that Tremont Partners and its members, directors, and officers, among others, "shall not be liable to any Limited Partner or the Partnership . . . to the fullest extent permitted by law." Vigna affirmation, exhibit A at 6. The only limitations in the exculpatory clause were for violations of securities laws, or "other intentional or criminal wrongdoing." *Id.* These terms are unambiguous on their face. *Retty Fin. v Morgan Stanley Dean Witter & Co.*, 293 AD2d 341, 341 (1st Dept 2002) ("limitation of liability provision within the parties' contract, providing that defendant would be subject to liability only for gross negligence or willful misconduct in its management of the subject investment fund, was unambiguous and applicable to the instant matter").

As discussed above, the Rye Select Fund is a Delaware limited partnership, and, therefore, Delaware law governs issues of its internal affairs. Partnership Law § 121-901. Under Delaware law, "[a] partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership." 6 Del Code § 17-1101 (f). "Where, as here,

directors are exculpated from liability except for claims based on 'fraudulent,' 'illegal' or 'bad faith' conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper." *Wood v Baum*, 953 A2d 136, 141 (Del 2008). As discussed above in connection with Wexler's fraud claim, the amended complaint fails to allege scienter. Therefore, the exculpatory clause of the LP Agreement bars Wexler's claim for negligent misrepresentation. *See also SNS Bank v Citibank*, 7 AD3d 352, 355 (1st Dept 2004) ("plaintiff's claim that Citibank breached the financial management agreement by making improper, imprudent, and unsuitable investments would be barred by that contract's exculpatory clause").

In opposition, Wexler refers to the legal arguments raised by Donna McBride (McBride) in her related action under Index Number 650632/09. There, McBride argues that the LP Agreement is an unenforceable "contract of adhesion." McBride opp brief, at 24. To determine whether a contract constitutes an adhesion contract, the plaintiff's claim is "judged 'by whether the party seeking to enforce the contract has used high pressure tactics or deceptive language in the contract and whether there is inequality of bargaining power between the parties.'" *Morris v Snappy Car Rental*, 84 NY2d 21, 30 (1994). Here, however, Wexler fails to cite any legal authority supporting his theory that a limited partnership agreement such as the LP Agreement is an adhesion contract. Nor does the amended complaint allege any "high pressure tactics," "deceptive language," or "inequality of bargaining power." *Id.* To the contrary, as discussed above, Wexler represented in the PPM and the Subscription Agreement that he was an "accredited investor," a "qualified purchaser," and that he was a "sophisticated investor" with "knowledge and experience in financial and business matters." Vigna affirmation, exhibit B at

22, and exhibit D at S-11, S-14, and S-19. He was also invited "to review any materials available to the General Partner" relating to the offering. *Id.*, exhibit B at 62. These representations "foreclose an adhesion claim" by Wexler. *Kopple v Stonebrook Fund Mgt., LLC*, 21 Misc 3d 1144(A), *4, 2004 NY Slip Op 51948(U) (Sup Ct, NY Count 2004), *affd* 18 AD3d 329 (1st Dept 2005).

Wexler also argues (through McBride) that the exculpatory clause is unenforceable, because a "special relationship" may have existed between the parties, thereby raising a factual issue that precludes dismissal. McBride opp brief at 24. In support of this argument, McBride cites to *Drullinsky v Tauscher Cronacher Engrs.* (14 Misc 3d 1207[A]), 2006 NY Slip Op 52440[U] [Sup Ct, Nassau County 2006]). In *Drullinsky*, the court stated that "[g]enerally, a 'special relationship' analysis has taken place in the context of determining whether a duty should be imposed where one would not otherwise exist." *Id.* at *3. As in *Drullinsky*, however, "[h]ere the question is not whether a duty existed, but whether a contractual provision limiting liability should be enforced." *Id.* As discussed above, having failed to allege scienter, the exculpatory clause bars Wexler's negligent misrepresentation claim against Tremont Partners.

The negligent misrepresentation claim also fails against Tremont Partners' parent company, Tremont Group (and its predecessor, Tremont Capital), because the amended complaint fails to allege "the existence of a special or privity-like relationship imposing a duty on [Tremont Group] to impart correct information to [Wexler]." *J.A.O. Acquisition Corp.*, 8 NY3d at 148. Nor does the pleading allege that Tremont Group imparted any information to Wexler. Therefore, Wexler fails to state a cause of action for negligent misrepresentation against Tremont Group. *Eurycleia Partners, LP v Seward & Kissel, LLP*, 46 AD3d 400, 401 (1st Dept 2007)

(dismissing negligent misrepresentation claim where "plaintiffs do not allege that [the defendant] made any representation, fraudulent or otherwise, to them"), *affd* 12 NY3d 553 (2009).

For the foregoing reasons, the eighth cause of action is dismissed against Tremont.

III. Rye Select Fund

The Rye Select Fund moves to dismiss the amended complaint, arguing that it is merely a nominal defendant against whom no causes of action are pled. The motion is unopposed.

The amended complaint names the Rye Select Fund as a nominal defendant only. Amended Complaint Caption and ¶ 71. None of the first eight causes of action are asserted against the Rye Select Fund. The ninth and tenth causes of action purport to assert direct claims for conversion and unjust enrichment against "all defendants" (*id.*, ¶¶ 506-516), but they fail to allege any wrongdoing by the Rye Select Fund. Moreover, as discussed above, the ninth and tenth causes of action are not direct claims, but rather, they are derivative claims that belong to the Rye Select Fund, and these claims are barred by res judicata. As Wexler asserts no individual claims against the Rye Select Fund, the Rye Select Fund is merely a "passive litigant," and, therefore, the motion to dismiss is granted to the extent of dismissing any and all claims seeking monetary recovery against this defendant (as opposed to surviving claims that seek recovery on behalf of this defendant). *Garlen v Green Mansions*, 9 AD2d 760, 760 (1st Dept 1959) ("a corporation is usually a passive litigant in a stockholder's derivative action").

Accordingly, it is hereby

ORDERED that the motions of defendants Massachusetts Mutual Life Insurance Company, Oppenheimer Acquisition Corp., Sandra Manzke, Tremont Partners, Inc., Tremont Group Holdings, Inc., Tremont Capital Management, Inc., and Robert Schulman (motion

sequence numbers 022, 030, 033, and 034 respectively) to dismiss the amended complaint herein are granted and the amended complaint is dismissed in its entirety against said defendants, with costs and disbursements to these defendants as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendants; and it is further

ORDERED that the motion to dismiss of nominal defendant Rye Select Broad Market Prime Fund, L.P. (motion sequence number 032) is granted to the extent of dismissing any and all claims seeking monetary recovery against this defendant; and it is further

ORDERED that the action is severed and continued against the remaining defendants.[7]

Dated: April 1, 2014

ENTER:

J.S.C.

HON. [illegible] E III

[7] The outstanding motions to dismiss of defendants KPMG, The Bank of New York Mellon, JP Morgan, and Paul Konigsberg will be addressed in a separate decision.