SANDBERG PHOENIX

PROFESSIONAL LIABILITY BLOG

Bernie Madoff Strikes Again: the Lasting Consequences of His Ponzi Scheme are Still Being Felt

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The “Bernie Madoff Scandal” broke on December 11, 2008, when the FBI arrested the eponymous chairman of Bernard L. Madoff Investment Securities LLC (“BLMIS”), and charged him with one count of securities fraud. He later pled guilty to 11 counts of securities fraud. Seven years later, the effects of his Ponzi scheme, believed to be the largest in U.S. history, are still being felt as court rulings on the matter continue to come down.

On February 9, 2015, the U.S. Court of Appeals for the Second Circuit issued its opinion in *DeLollis v. Friedberg, Smith & Co., P.C.* The case arose out of the Empire State Carpenters Welfare, Annuity, and Pension Funds (“Empire”) investing in Beacon Associates entities (“Beacon”) between December 2003 and December 2008. Beacon then invested a large majority of its assets in Bernie Madoff’s fraud empire. Friedberg, Smith & Co., P.C. (“Friedberg”) served as an independent auditor for Beacon and performed annual audits on Beacon’s financial statements. In addition to its investments with Beacon, Empire also invested other amounts directly with Madoff-related entities.

Friedberg’s annual Beacon audits did not recognize that the investments in BLMIS were not as reported, and that the purported brokerage statements were fraudulent. Due to Madoff’s fraud, Empire suffered substantial investment losses. Its trustees filed suit on Empire’s behalf and alleged Friedberg should have obtained sufficient audit evidence from BLMIS to permit Friedberg to uncover Madoff’s fraud.

Lower Court’s Analysis

The district (lower) court held Friedberg did not owe a duty to Empire regarding Madoff-related investments not made through Beacon. As to Empire’s investments with Beacon, the court held Empire adequately pled “near privity” (essentially meaning there was a close enough connection among Friedberg, Empire, and Beacon to potentially lead to liability for Friedberg). Despite this finding, the district court held Empire did not adequately plead claims falling within the scope of Friedberg’s duty to Empire. The district court dismissed all claims and concluded that any amendment of the claims by Empire would be futile, because auditors do not

function as insurers for investors and do not have a duty to uncover third-party fraud.

Appellate Court Review

On appeal, the Second Circuit applied New York law, which holds an auditor has a “near privity” duty to a non-contracting third party if three prerequisites are met: (1) the auditor must have been aware the financial reports were to be used for a particular purpose or purposes; (2) a known party was intended to rely on the reports for a particular purpose or purposes; and (3) there must have been some conduct on the auditor’s part linking it to that party that evidences the auditor’s understanding of the reliance.

The Second Circuit held Empire sufficiently pled “near privity” on the Beacon investments, because Friedberg addressed reports directly to Empire, and Friedberg was aware its reports would be used by Empire to invest in Beacon and that Empire would rely on Friedberg’s reports to make those investments.

The Second Circuit also agreed with the district court that Empire could not establish Friedberg owed Empire a duty within the scope of Empire’s claims. It concluded Friedberg’s duty, as a matter of law, did not include investigating the conduct of a non-client third party. The appellate court noted that auditing standards make clear Friedberg is not an insurer, and that an audit report does not constitute a guarantee. According to the court, holding otherwise would require auditors to audit every company in which its client had invested – an untenable position.

The Takeaway

Given Friedberg’s lack of liability in this case, the question arises, “What should those in Empire’s position do to better protect themselves?” Investors that place funds in companies that then re-invest those funds in other corporations cannot count on courts to bail them out if things head south – even if fraud is involved.

Though there is no simple answer to completely avoid this risk, two familiar sayings come to mind: “Don’t put all your eggs in one basket,” and “If it seems too good to be true, it probably is.” Now, to be fair, the SEC had investigated Madoff on multiple occasions and failed to catch his fraud. It took an FBI investigation to do so. Nonetheless, if an investor wishes to limit risk, it should sufficiently spread out its investments. If a company “guarantees” and delivers impossible returns (or all-too-consistent returns), the situation may be too good to be true. At the end of the day, as the DeLollis case suggests, don’t expect a court to hold an auditor responsible in these situations.

By Tyler Thompson

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