SHORT FORM ORDER

SUPREME COURT - STATE OF NEW YORK

Present:

HON. STEPHEN A. BUCARIA

Justice

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TRIAL/IAS, PART 2
NASSAU COUNTY

JOEL SACHER and SUSAN SACHER, derivatively on behalf of BEACON ASSOCIATES LLC II,

INDEX No. 005424/09

MOTION DATE: April 21, 2010

Plaintiffs,

Motion Sequence # 005, 006, 007, 008

-against-

BEACON ASSOCIATES MANAGEMENT CORP., IVY ASSET MANAGEMENT CORP., IVY ASSET MANAGEMENT LLC, FRIEDBERG, SMITH & CO., P.C., JOEL DANZIGER and HARRIS MARKHOFF,

Defendants,

BEACON ASSOCIATES LLC II,

Nominal Defendant.

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The following papers read on this motion:

Notice of Motion...................................... XXXX
Affirmation/Affidavit in Opposition......... XX
Affidavit in Support.................................. X
Memorandum of Law................................ XXXXXXX
Reply Memorandum of Law....................... XXX

Motion by defendant Beacon Associates LLC II for a stay is **granted**. Motion by defendants Beacon Associates Management Corp., Joel Danziger, and Harris Markhoff to dismiss the complaint is **denied**, and their alternative motion for a stay is **granted**. Motion by defendant Friedberg, Smith & Co. to dismiss the complaint is **denied**. Motion by defendants Ivy Asset Management Corp. and Ivy Asset Management LLC to dismiss the complaint is **granted** in part and **denied** in part.

This derivative action against the managing member of an investment company, its investment consultant, and the company's auditor arises from the collapse of Bernard L. Madoff Investment Securities. Two other actions asserting almost identical claims are also pending in this court. ***Hecht v Andover Associates***, No. 6110/09, is assigned to the undersigned, and ***Bailey v Peerstate***, No.12439/09, is assigned to Justice Driscoll.

Beacon Associates, LLC II ("Beacon Associates") was a New York limited liability company formed for the purpose of investing and trading for its own account "in securities, financial instruments and commodities of every kind and description." The firm commenced operations March 1, 1995, and it is governed by an amended and restated operating agreement.

Beacon Associates' amended and restated operating agreement provides that the managing member is defendant Beacon Associates Management Corp. ("Beacon Management"). Defendant Joel Danziger is the president and a director of Beacon Management, and defendant Harris Markhoff is the vice president, secretary, treasurer and a director of the corporation. The office of Beacon Associates and Beacon Management was located at 123 Main Street, Suite 900, White Plains, New York.

The amended and restated operating agreement provides that the managing member shall make the "ordinary and usual decisions concerning the business affairs" of the company. The managing member's duty of care in discharging its duties is limited to "refraining from engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law." The managing member is to be "fully protected in relying in good faith upon...investment managers or agents...as to matters the managing member reasonably believes are within such other person's professional or expert competence and who have been selected with reasonable care by or on behalf of the company...." As compensation for managing the company, the managing member is to receive a monthly "managing member fee" of .125 % of the "capital account balance of each member (other than the managing member) attributable to non-Beacon net worth." Non-Beacon net worth" is defined as total assets of the company not committed to Beacon investments less liabilities not related to Beacon investments. The operating agreement further provides that the investment consultant fee shall be paid by the managing member from the managing member fee and shall not be charged to the company.

On February 17, 1995, Ivy Asset Management entered into an "administrative services" agreement with Beacon Management. The agreement recited that Ivy had introduced Danziger and Markhoff to Madoff and that they intended to form "Beacon Associates, LLC" for the purpose of pooling investment funds to be managed by Madoff. The agreement further recited that Beacon Management was to be the sole managing member of the LLC and that Ivy would provide certain administrative services for Beacon Management. Those services included, among other things, maintaining the capital accounts of the LLC members, reconciling all Madoff statements against "trade tickets," and maintaining "original books of entry for all Madoff activity," including "purchase and sales activity." As compensation for these services, Ivy was to be paid 50% of all fees received by the managing member from the LLC. On January 1, 2006, Ivy entered into an agreement with Beacon Associates to provide administrative services "of the same nature" directly to the LLC for a fee of $70,000 per year. Pursuant to a January 1, 2008 amendment to the administrative services agreement, Ivy's annual fee was changed to .1% of the net capital of the LLC.

In June, 2000, Beacon Associates issued a "confidential offering memorandum," offering prospective investors the opportunity to invest in the limited liability company. Although the offering memorandum referred to the interests it was offering as "securities," it stated that the offering was not a "public offering." The offering memorandum stated that the "investment objective" of the partnership was to provide "above average rates of return while attempting to minimize risk." However, the offering memorandum stated that the investment was not suitable for someone who could not "afford a loss of principal" or had "need for liquidity." It further stated that the "minimum initial purchase" was $500,000.

The offering memorandum contained a liability and indemnification provision which provided that, "Neither the managing member, nor the investment consultant, or their respective shareholders, officers, directors...will be liable ...to the company or any of the members for any act or omission performed or omitted to be performed...in a manner reasonably believed by it or them 1) to be within the scope of the authority granted...by the LLC agreement, and 2) to be in the best interests of the company or the members (... 'good faith acts'), except when such action or failure to act is found to be the result of gross negligence, fraud, or willful misconduct." A similar indemnification and limitation of liability provision was contained in the amended and restated operating agreement.

On November 28, 2005, Beacon Management entered into a "letter agreement" with Ivy Asset Management Corp. The letter agreement recited that Ivy was currently performing consulting services for Beacon Management as well as administrative services to Beacon Associates LLC I and Beacon Associates LLC II. The agreement recited that as compensation for performing these services, Ivy was currently being paid 45% of the managing member fees received by Beacon Management from Beacon Associates I and II, and 50% of the managing member's "1 % profit allocation." The agreement further recited that "historically" Beacon Management had paid the entire amount of these fees out of its managing member fees, even though the operating agreements required the companies to pay for their own administrative services. The letter agreement recited that, effective January 1, 2006, Beacon Associates I and II would begin paying Ivy a total of $70,000 per year, which was the portion of Ivy's total fees which Ivy had determined should be "allocated" to the administrative services.

On January 1, 2006, Beacon Management entered into a consulting agreement with defendant Ivy Asset Management Corp. The consulting agreement recites that Ivy originally recommended Madoff to Beacon Management and that Beacon Management "continues to utilize the strategies implemented by Madoff." The consulting agreement provided that Ivy would recommend other investment managers to Beacon Management and advise the company as to the "allocation of LLC funds" among investment managers, including "timing of retaining and terminating investment managers other than Madoff." In the agreement, the parties acknowledged that Beacon Management had expressly requested that Ivy "not monitor or evaluate or meet with any representatives of Madoff...or with any non-recommended manager." Although Ivy agreed to use reasonable care in providing these services, it was not to "be responsible or held accountable for any act or failure to act by investment managers regardless of whether it recommends such managers or by Madoff."

As compensation for performing the consulting services, Ivy was to receive 40% of the managing member fees received by Beacon Management from January 1 through December 31, 2006. Commencing January 1, 2007, Ivy was to receive 37.5 % of the managing member fees received by Beacon Management. Additionally, Ivy agreed to indemnify Beacon Management for all claims arising from Ivy's gross negligence or wilful misconduct, and Beacon Management agreed to indemnify Ivy for claims arising from similar conduct on the part of Beacon Management.

Although plaintiffs allege that they were members of Beacon Associates "at all relevant times," they do not set forth the amount of their investment or the circumstances surrounding the acquisition of their interests. Nevertheless, plaintiffs allege that in 1995, upon the recommendation of Ivy, Beacon Associates invested all of its assets with Madoff. For a number of years, Madoff paid Beacon Associates a high rate of return on its investment. However, in December, 2008, it became known that Madoff had been running a "Ponzi scheme," whereby no profits were actually being earned but rather earlier investors were paid "profits" from the capital of newer investors. Madoff subsequently declared bankruptcy and was convicted of fraud, perjury, and other crimes in connection with his criminal enterprise. While the percentage of Beacon Associates' assets invested with Madoff had fluctuated over the years, at the time of his collapse, 75%, or $75 million, of Beacon Associates' assets were invested with Madoff.

The present action was commenced on March 24, 2009. Plaintiff purports to sue derivatively on behalf of Beacon Associates. In addition to Danziger, Markhoff, and Beacon Management, plaintiff names as defendants Ivy and Friedberg, Smith & Co. P.C., who is the auditor for Beacon Associates. Ivy Asset Management Corp. became a limited liability company on January 1, 2009. Plaintiff has named both the corporation and the LLC.

The first cause of action is asserted against Ivy for breach of the 1995 administrative services agreement by failing to reconcile Madoff's monthly statements against the trade tickets. Plaintiffs allege that had Ivy attempted to reconcile Madoff's monthly statements, it would have discovered that there were no trade tickets because no trades were ever executed. Thus, plaintiffs allege that, but for Ivy's failure to reconcile the statements, Madoff's fraud would have been discovered earlier and Beacon Associates would have been able to withdraw its investment. Plaintiffs claim that, as a result of Ivy's breach of the administrative services agreement, Beacon sustained damages in the amount of approximately $75 million, allegedly the value of its Madoff investment.

The second cause of action is asserted against Ivy for breach of the 2006 administrative services agreement. Similar to the first cause of action, plaintiffs allege that Ivy breached this agreement by failing to reconcile Madoff's monthly statements against the trade tickets.

The third cause of action is asserted against Beacon Management for breach of the operating agreement. Plaintiffs allege that Beacon Management violated the provision in the operating agreement that the investment consultant's fee shall not be charged to the company by arranging for the administrative services fee to be paid by Beacon Associates.

The fourth cause of action is asserted against Ivy for negligence. Plaintiffs allege that Ivy was negligent in recommending Madoff as an investment manager without conducting sufficient due diligence investigation of his operation.

The fifth cause of action is asserted against Beacon Management for gross negligence. Plaintiffs allege that Beacon Management was grossly negligent by investing a substantial portion of Beacon's assets with Madoff without conducting a sufficient due diligence investigation.

The sixth cause of action is asserted against Beacon Management for breach of fiduciary duty. Plaintiffs allege that Beacon Management breached its fiduciary duty of loyalty by entering into the 2006 consulting agreement, whereby Ivy disclaimed any responsibility for monitoring Madoff; causing Beacon Associates to enter into the 2006 administrative services agreement in violation of the provision in the operating agreement that the investment consultant fee not be paid by the company; and causing Beacon to enter into the 2008 amendment to the administrative services agreement resulting in an increase in the administrative services fee.

The seventh cause of action is asserted against Danziger and Markhoff for aiding and abetting Beacon Management to breach its fiduciary duty. The eighth cause of action is asserted against Ivy for aiding and abetting Beacon Management's breach of fiduciary duty. The ninth cause of action is asserted against Friedberg, Smith for auditor's negligence. Plaintiffs allege that Friedberg, Smith failed to conduct a proper audit, including "obtaining confirmations of portfolio securities purportedly held by Madoff's firm." Plaintiffs assert that but for the auditor's negligence, Beacon Associates would not have invested 75% of its assets with Madoff. Plaintiffs allege that serving a demand upon Beacon Management to prosecute these claims would have been futile because Beacon Management and its principals were involved in the wrongdoing constituting the basis of the claims.

Defendants Danziger, Markhoff, and Beacon Management move to dismiss the amended complaint pursuant to CPLR 3211(a)(3) for lack of capacity to sue and pursuant to CPLR 3211(a)(7) for failure to state a cause of action. Defendants argue that plaintiffs lack capacity to sue on behalf of Beacon Associates because they failed to make a demand upon the managing member of the limited liability company. Defendants argue that plaintiffs' claims for breach of fiduciary duty, gross negligence, and aiding and abetting breach of fiduciary duty are precluded by the Martin Act, General Business Law §§ 352, 353. Defendants further argue that plaintiffs' claims for breach of the operating agreement, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and gross negligence are barred by the business judgment rule. Defendants argue that plaintiffs' claims for breach of contract, breach of fiduciary duty, and aiding and abetting breach of fiduciary duty are precluded by the limitation of liability provisions contained in the offering memorandum and amended and restated operating agreement. Defendants argue that plaintiffs' claims for breach of fiduciary duty are duplicative of their claims for breach of contract. Defendants argue that plaintiffs' claim against Beacon Management for gross negligence is legally insufficient because its conduct does not evince a reckless disregard for the rights of others.

Defendants argue that plaintiffs' claim against Beacon Management for breach of the operating agreement by arranging for Beacon Associates to pay Ivy's administrative services fee is legally insufficient. Defendants argue that Beacon Associates' paying of the administrative services fee is expressly permitted by ¶ 8.2 of the operating agreement, which is entitled "Payment of Organization Expenses and Other Expenses. The paragraph provides, "The company also will pay for all customary direct and indirect overhead and operating expenses incurred in its operation,..., (including...secretarial and other employee compensation and benefits, rent, telephone, postage, supplies, and other administrative expenses), in an amount not to exceed 1% of the company's net worth..." Defendants argue that Beacon Associates' paying of Ivy's administrative services fee is also permitted by the paragraph entitled "Operational Expenses" in the offering memorandum. That paragraph states that "the company will pay its own... customary direct and indirect overhead and operating expenses incurred in its operation in an amount not to exceed 1% of the company's net worth....".

Defendant Ivy moves to dismiss the complaint on the ground that plaintiffs lack standing to assert derivative claims on behalf of Beacon Associates because they failed to make a pre-suit demand upon the managing member. Ivy further argues that plaintiffs have not established that a demand upon Beacon Management would have been futile.

Ivy argues that Beacon Associates was not a third party beneficiary of the 1995 administrative services agreement and that Ivy did not breach either the 1995 or the 2006 administrative services agreement. Ivy argues that plaintiffs' negligence claim is insufficient because any duty to perform due diligence ran to Beacon Management, rather than Beacon

Associates. Ivy argues that plaintiffs' negligence claim is precluded by the Martin Act. Ivy argues that plaintiffs' negligence claim is merely a claim for breach of an oral contract, which is unenforceable under the statute of frauds. Ivy argues that plaintiffs' negligence claim is untimely because, since the consulting agreement barred contact with Madoff, any claim for negligence accrued by January 1, 2006. Ivy argues that plaintiffs' claim for aiding and abetting breach of fiduciary duty lacks merit because Ivy did not know that Beacon Management breached its fiduciary duty to Beacon Associates and did not provide Beacon Management with substantial assistance. Finally, Ivy argues that plaintiffs' claim for aiding and abetting breach of fiduciary duty is precluded by the Martin Act. Ivy joins in Beacon Management's motion to stay the present action, pending resolution of the consolidated actions in federal court.

Defendant Friedberg, Smith & Co. moves to dismiss the complaint for lack of capacity on the ground that plaintiffs failed to make a pre-suit demand on Beacon and have failed to make a showing of futility. Friedberg, Smith argues that plaintiffs' negligence claim is insufficient because Madoff's criminal conduct was an "intervening act" that breaks any causal connection between defendant's audit and the loss suffered by the fund. Defendant argues that plaintiffs' claims are barred by the doctrine of *in pari delicto* because the wrongful conduct of Beacon Management, Danziger, Markhoff, and Ivy must be imputed to Beacon Associates. Defendant argues that plaintiffs' claim for auditor negligence is precluded by the Martin Act. Finally, defendant argues that plaintiffs' negligence claim is time-barred to the extent that it accrued prior to March 23, 2006.

In the alternative, defendants Beacon Management, Danziger, and Markhoff move pursuant to CPLR 3211(a)(4) to stay the present action pending resolution of related cases which have been consolidated in the United States District Court for the Southern District of New York. Defendant Beacon Associates moves for a stay pending resolution of the federal actions pursuant to CPLR § 2201.

By order dated May 13, 2009, Judge Sand consolidated ***Cacoulidis v Beacon Associates Management*** (No. 09 civ 0777); ***Raubvogel v Beacon Associates, LLC I*** (No. 09 civ 2401); and ***Plumbers Local 112 Health Fund v Beacon Associates Management***, (No. 09 civ 3202). The *Cacoulidis* action was filed on January 27, and the ***Raubvogel*** action was filed on March 15, 2009. A fourth case, ***Towsley v Beacon Associates Management***, (No. 09 civ 4453) was also covered by the consolidation order.

A consolidated amended class action and derivative complaint was filed in the federal court on October 1, 2009. Beacon Management, Danziger, Markhoff, Ivy, and Friedberg, Smith are named as defendants in the consolidated federal action. The consolidated amended complaint asserts federal securities fraud claims pursuant to § 10(b) and of the Securities Exchange Act, 15 U.S.C. §§ 78j and Rule 10b-5 against Beacon Management, Ivy, and Friedberg. The complaint alleges that Beacon's offering memoranda contained materially false and misleading statements concerning "investment strategies and the level of supervision to be exercised over outside investment managers."

The consolidated amended complaint asserts claims pursuant § 20(a) of the Securities Exchange Act against Danziger and Markhoff. It alleges that as controlling persons, defendants had the power to influence and control the content and dissemination of the materially misleading statements in the offering memoranda.

In addition to the federal causes of action, the consolidated complaint asserts a number of pendent state claims. The consolidated complaint asserts breach of fiduciary duty claims pursuant to the Employee Retirement Income Security Act, 29 U.S.C. § 1104(a)(1) and § 1106(a)(1) against Beacon Management and Ivy. The complaint alleges that defendants violated the duties of prudence and loyalty by failing to investigate Madoff's investments and failing to identify "warning signs" about the suspicious nature of his operation. Additionally, the complaint asserts claims for co-fiduciary liability against Beacon Management and Ivy pursuant to § 1105(a)(1). ERISA imposes such liability on a fiduciary if he or she knows of a breach by another fiduciary and fails to remedy it.

The consolidated complaint asserts claims for common law fraud against Beacon Management, Ivy, and Friedberg. Plaintiffs allege that they would not have purchased their interests in the Beacon fund except for their reliance upon the false statements in the offering memoranda. Additionally, the complaint asserts claims against Ivy for aiding and abetting common law fraud. The complaint alleges that Ivy had actual knowledge of Beacon Management's misrepresentations and provided substantial assistance.

The consolidated complaint asserts claims for breach of fiduciary duty against Beacon Management and Ivy. The complaint alleges that Beacon Management violated its duty of due care in the management of Beacon Associates' assets.

The consolidated complaint asserts claims against Beacon Management for breach of Beacon Associates' operating agreement and breach of the offering memorandum based upon Beacon Management's failure to perform adequate due diligence.

The consolidated complaint asserts claims for negligent misrepresentation against Beacon Management, Ivy, and Friedberg, Smith. The complaint alleges that Beacon Management owed investors a duty to act with reasonable care in the preparation of the offering memoranda. The complaint alleges that Friedberg knew that its financial reports would be relied upon by investors and the class members are in privity with Beacon Management. The complaint alleges that defendants breached their duty of reasonable care by failing to disclose that they were not performing due diligence.

The consolidated complaint asserts claims against Beacon Management and Ivy for gross negligence and mismanagement. The complaint alleges that defendants were grossly negligent by investing the majority of Beacon Associates' assets with Madoff. The complaint asserts claims against Ivy and Friedberg for aiding and abetting breach of fiduciary duty by Beacon Management.

Additionally, the consolidated amended complaint asserts derivative claims on behalf of Beacon Associates and a related fund, Beacon Associates LLC I ("Beacon I"). A derivative claim for breach of fiduciary duty is asserted against Beacon Management, Ivy, and Friedberg. A derivative claim for breach of the operating agreement is asserted against Beacon Management, and a claim for breach of the consulting agreement is asserted against Ivy. The complaint alleges that defendants breached their respective agreements by breaching their fiduciary duties and engaging in grossly negligent, reckless, and intentional misconduct.

The consolidated complaint asserts a derivative claim for negligent misrepresentation against Beacon, Ivy, and Friedberg. A derivative claim for gross negligence and mismanagement is asserted against Beacon Management and Ivy. A derivative claim for aiding and abetting breaches of fiduciary duty by Beacon Management is asserted against Ivy.

The direct causes of action are brought as a class action on behalf of a class consisting of all investors in Beacon I or Beacon II who had not redeemed their interests as of December 11, 2008. Excluded from the class are the defendants named in the federal action, their officers and directors, any entity in which defendants had a controlling interest. Friedberg, Smith joins in Beacon Management, Danziger, and Markhoff's motion to stay the present action.

A member of a limited liability company may bring a derivative suit on behalf of the company, even though there is no provision authorizing such a suit in the Limited Liability Company Law (***Tzolis v Wolff***, 10 NY3d 100 [2008]). Where a minority shareholder brings a derivative suit on behalf of a corporation, the complaint must set forth with particularity plaintiff's demand upon the board of directors to bring the action, or the reasons that a demand would have been futile (Business Corporation Law § 626[c]); ***Bansbach v Zinn***, 1 NY3d 1, 8 [2003]). Shareholder derivative suits are not favored because they ask courts to second-guess the business judgment of the individuals charged with managing the company (Id). On the other hand, derivative actions protect minority shareholders against officers and directors who place other interests ahead of the corporation (Id). Thus, a demand is futile when the complaint alleges with particularity that 1) a majority of the board of directors is interested in the challenged transaction, 2) the board members did not fully inform themselves about the challenged transaction to the extent reasonably appropriate in the circumstances, or 3) the transaction was so egregious on its face that it could not have been the product of sound business judgment (***Bansbach***, 1 NY3d at 9). Director interest may be either self-interest in the transaction at issue or a loss of independence because a director with no direct interest in the transaction is controlled by a self-interested director (Id). A similar demand or futility requirement applies to a derivative suit on behalf of a limited liability company.

Clearly, Beacon Management has an interest in not being sued for breach of the operating agreement, gross negligence, or breach of fiduciary duty. Similarly, Beacon Management has an interest in protecting its principals, Danziger and Markhoff, from being sued for aiding and abetting a breach of fiduciary duty by Beacon Management. The court determines that Beacon Management also has an interest in protecting Ivy from being sued for breach of the administrative services agreements, negligence, or aiding and abetting a breach of fiduciary duty by Beacon Management. The court further determines that Beacon Management has an interest in protecting Friedberg, Smith from being sued for auditor's negligence. If it were established in such an action that Ivy failed to exercise due diligence or that Friedberg, Smith failed to conduct a proper audit, these facts would tend to establish that Beacon Management negligently breached its own fiduciary duty to Beacon Associates. Accordingly, defendants' motions to dismiss the amended complaint for lack of capacity based upon plaintiff's failure to show that a demand was futile is **denied**.

On a motion to dismiss pursuant to CPLR 3211, the pleading is to be afforded a liberal construction. The court must accept the allegations of the complaint as true and provide plaintiff the benefit of every possible favorable inference (***AG Capital Funding Partners v.***

State Street Bank and Trust Co., 5 NY3d 582, 591 [2005]). The business judgment rule bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes (***Consumers Union v New York***, 5 NY3d 327, 360 [2005]). Beacon Management, Danziger, and Markhoff argue that the business judgment rule insulates their decisions to utilize Ivy as their investment consultant and Madoff as their investment manager. However, the issue is not whether defendants were in good faith in failing to detect Madoff's fraud but whether were defendants in bad faith in not bringing suit after the fraud was uncovered. Providing plaintiffs the benefit of every possible favorable inference, the court must assume that Beacon Management's decision not to proceed against Ivy or Friedberg, Smith was not in good faith.

The retaining of Ivy as the investment consultant, and the amount of compensation which Ivy was paid for investment consulting and administrative services, would ordinarily be within Beacon Management's business judgment. However, administrative services included maintaining "original books of entry for all Madoff activity," presumably including his fictitious trades. Plaintiff alleges that there were no trade tickets, or any other documentation, to substantiate the trades. Giving plaintiff the benefit of every possible favorable inference, Ivy's preparing original books of entry, without the benefit of back up documentation, may have furthered Madoff's scheme or helped to avoid its detection. In any event, in view of the provision in the operating agreement, prohibiting payment of the investment consultant's fee from company assets, the court cannot conclude that the arrangement concerning the administrative services fee was in good faith. Accordingly, defendants' motion to dismiss based upon the business judgment rule is denied. For similar reasons, the limitation of liability provisions in the operating agreement and offering memorandum do not bar plaintiff's claims.

A trustee is under a duty to employ diligence and prudence in the management of the trust estate (***In re Marine Midland Bank***, 127 AD2d 999 [4th Dept 1987]). Delegation of this duty to another is not an excuse for the failure to fulfill it by the trustee (Id). Nor does the trustee's good faith and honesty of purpose relieve him from a breach of his fiduciary obligation (Id). In essence, plaintiff's theory is that Beacon Management breached the duty of diligence and prudence by delegating management of Beacon Associates' investments to Madoff without conducting an adequate investigation into his operation. Since plaintiffs' claim for breach of the operating agreement is based on the provision prohibiting payment of the investment consultant's fee from partnership assets, plaintiffs' claim for breach of fiduciary duty is not duplicative of their breach of contract claim (See ***Perl v Smith Barney,***

Inc., 230 AD2d 664, 666 [1st Dept 1996]).

Although defendants acknowledge that they owed investors a duty of care and loyalty in the management of Beacon Associates' assets, they argue that the Martin Act precludes plaintiffs' breach of fiduciary duty, aiding and abetting, and gross negligence claims. "The Martin Act authorizes that Attorney General to investigate and enjoin fraudulent practices in the marketing of stocks, bonds and other securities within or from New York State" (***Kerusa Co. v Real Estate LP***, 12 NY3d 236, 243 [2009]). General Business Law § 352 (1) provides that "Whenever it shall appear to the attorney-general. . .that in the issuance, exchange, purchase, sale. . .investment advice. . .of any stock, bonds, notes, evidences of interest or indebtedness, or other securities. . .any person, partnership, corporation, company . . .shall have employed. . .any device, scheme or artifice to defraud. . .he may in his discretion either require or permit such person. . .to file with him a statement. . .as to all the facts and circumstances concerning the subject matter. . ." Pursuant to General Business Law §353 (1), the attorney-general may bring an action to enjoin such persons from continuing such fraudulent practices. The Act also makes it illegal to make or take part in a public offering of securities consisting of participation interests in real estate, including coops and condominiums, unless an offering statement is filed with the Attorney General (General Business Law § 352-e[1][a]). The disclosure provided by the offering statement is "designed to protect the public from fraudulent exploitation in the sale of real estate securities" (***Kerusa Co.***, 12 NY3d at 243). Because the Martin Act is designed to protect the public from fraudulent exploitation in the offering and sale of securities, a "private offering" of securities is exempt from the coverage of the Act (***People v Landes***, 192 AD2d 1, 4 [3d Dept 1993]).

The Martin Act authorizes the Attorney General to seek restitution and damages for parties who have been injured by a violation of the Act (General Business Law § 353[3]). However, the Attorney General need not allege or prove *scienter*, the intent to deceive element in a common law fraud action, to establish liability for fraudulent practices under the Martin Act" (***Caboara v Babylon Cove Dev.***, 54 AD3d 79, 81 [2d Dept 2008]).

Because "the attorney-general bears sole responsibility for implementing and enforcing the Martin Act, there is no private right of action under the statute" (***Kerusa Co.*** 12 NY3d at 244). Moreover, to avoid "a backdoor private cause of action to enforce the Martin Act," common law causes of action based upon conduct covered by the Act are precluded or "preempted" (Id at 245). However, plaintiff may participate in a business venture without acquiring a "security" in a "public offering," and promoters may defraud investors after the securities offering has taken place. Thus, whether plaintiff's particular claim is precluded by the Martin Act "varies from case to case" (***Owens v Gaffken & Barriger Fund***, 2009 U.S. Dist. LEXIS 90895 [SDNY 2009]).

According to the *Howey* test, a particular interest will be a "security," if "looking at the economic realities, the transaction involved an investment of money in a common enterprise with profits to come solely from the efforts of others" (***All Seasons Resorts v Abrams***, 68 NY2d 81, 92 [1986]). Clearly, plaintiffs invested their money in a common enterprise, Beacon Associates, with the expectation that profits would come solely from the efforts of Beacon Management, or the manager to whom it delegated the operation of the fund. Indeed, the Beacon Associates offering memorandum refers to the limited liability membership interests which it was offering as "securities." The court concludes that the membership interests offered by Beacon Associates were securities within the meaning of the Martin Act.

Beacon Associates' offering memorandum stated that it was not open to the general public. Taking the offering memorandum at face value, Beacon's limited liability membership interests were not marketed in a public offering, and the Martin Act would not preclude plaintiffs' common law claims. Nevertheless, a statement in an offering memorandum that an offering is not a "public offering" may be self-serving with respect to the issue of whether the securities are subject to federal regulation or regulation under the Martin Act. In determining whether a particular offering constitutes a public offering under the Martin Act, the court may consider factors relevant under federal law, including the sophistication of the offerees and their need for the protection of the securities acts (***People v Landes***, **supra**, 192 AD2d at 4). As under federal law, the court may also consider the number of offerees, the number of units offered, and the size and manner of the offering (Id).

While there is no evidence as to the number of people who were offered interests in Beacon Associates, the offering memorandum indicates that the offer was made in at least two states other than New York. Despite the boilerplate disclaimers in the offering memorandum, it appears that plaintiffs may have been in need of the protection of the Martin Act. Since Beacon Associates' offering of limited liability membership interests may have involved a public offering, the court must consider whether Beacon Management was involved in a "fraudulent practice" in the marketing of the membership interests.

Since the Attorney General need not prove *scienter* to establish a Martin Act violation, claims sounding in fraud are "routinely dismissed," whether or not they require proof of fraudulent intent (***Owens v Gaffken & Barrige Fund***, **supra**, 2009 U.S. Dist. LEXIS 90895). Thus, a purchaser of a condominium unit will be precluded from bringing a fraud action against the sponsor based upon material omissions in the offering plan (***Kerusa Co. v Real Estate LP***, **supra**, 12 NY3d at 245). Similarly, a purchaser of a coop will be precluded from asserting a claim for negligent misrepresentation or breach of the fiduciary duty of disclosure based upon misleading statements extrinsic to the offering plan (***Horn v 440 East 57th Street Co.***, 151 AD2d 112, 120 [1st Dept 1989]). In ***Horn***, the court reasoned that the existence of a fiduciary relationship had been "substituted" for the element of intent to deceive in a fraud action.

Where an investment advisor recommends a hedge fund without conducting sufficient due diligence, an investor's breach of fiduciary duty claim "arises in the securities context" (***Bayou Hedge Fund Litigation***, 534 F. Supp.2d 405, 422 [SDNY 2007]), *aff'd sub nom*., ***South Cherry St. v Hennessee Group***, 573 F.2d 98 [2d Cir. 2009]). Such a claim will be precluded by the Martin Act, regardless of whether it involves an element of deception, because it is "related to a securities fraud claim" (Id at 421). Similarly, where a claim for breach of fiduciary duty is based upon a "significant component" of the representations that induced plaintiff to invest, the claim arises from the alleged securities fraud and is preempted by the Martin Act (***Heller v Goldin Capital***, 590 F. Supp. 2d 603, 612 [SDNY 2008]). In ***Heller***, a claim for breach of fiduciary duty based upon misrepresentations as to a fund's capitalization and diversification was preempted. Similarly, claims against a fund for unjust enrichment and conversion, based upon misrepresentations as to the investment's level of risk, are precluded as merely "recast securities fraud claims" (***Owens v Gaffken & Barrige Fund***, **supra**, 2009 U.S. Dist. LEXIS 90895).

While the limited liability membership interests in Beacon Associates were securities, plaintiffs' breach of fiduciary duty claim does not relate to fraud in connection with the sale of the membership interests. Rather than Beacon Management giving plaintiff any investment advice, plaintiffs entrusted their money to Beacon Associates so that it could make the investments. Plaintiffs allege that Beacon Management breached its fiduciary duty by failing to exercise diligence and prudence, not with respect to investment recommendations, but in the management of Beacon Associates' investments. Thus, plaintiffs' breach of fiduciary duty claim does not arise from alleged securities fraud and is not simply a recast securities fraud claim. Defendants' motion to dismiss is **denied** to the extent that it argues that plaintiffs' claim against Beacon Management for breach of fiduciary duty and their claim against Danziger and Markhoff for aiding and abetting breach of fiduciary duty are preempted by the Martin Act.

Gross negligence is the failure to exercise even "slight care" or "slight diligence" (***Gentile v Garden City Alarm***, 147 AD2d 124, 131 [2d Dept 1989]). It is conduct that is so careless as to show complete disregard for the rights and safety of others (Id). While Beacon Management denies that it knew of Madoff's scheme, if may be inferred that Beacon Management failed to exercise even slight care in failing to detect it. Similarly, it may be inferred that in entrusting Beacon Associates' funds to Madoff, Beacon Management showed complete disregard for Beacon Associates' rights and the safety of its investment. That public regulators also failed to uncover the fraud does not establish that Beacon Management was diligent. Defendants' motion to dismiss plaintiffs' gross negligence claim for failure to state a cause of action is **denied**.

Additionally, because defendants' gross negligence is not based upon a significant component of the representations that induced plaintiffs to invest, it is not a recast securities fraud claim. Defendants' motion to dismiss plaintiffs' gross negligence claim as preempted by the Martin Act is **denied**.

Plaintiffs claim that Beacon Management breached the provision in the operating agreement, prohibiting the investment consultant's fee from being paid from company assets, by arranging for Beacon Associates to pay Ivy an "administrative services fee," which, plaintiffs allege, was merely a disguised fee for the investment consultant. In moving to dismiss this claim, Beacon Management argues that the administrative services agreement did not cover investment consulting services. However, the offering memorandum states that "The investment consultant's responsibilities to the managing manager include monitoring of ongoing manager performance and client record-keeping, continuing communications with the managing member and related services." Thus, the line between "administrative services" and investment consulting may have been hard to draw. Because Ivy was responsible for maintaining original records of Madoff's trades, the line may have been particularly vague with respect to the Madoff investment. In any event, the court cannot conclude that the administrative services fee was not a disguised fee for the investment consultant. Defendant Beacon Management's motion to dismiss plaintiffs' claim for breach of the operating agreement for failure to state a cause of action is **denied**.

The threshold question in any negligence action is whether defendant owes a legally recognized duty of care to plaintiff (***Hamilton v Beretta Corp.***, 96 NY2d 222, 232 [2001]). The duty is defined "by balancing several factors, including the reasonable expectations of the parties and society generally, the proliferation of claims, the likelihood of unlimited or insurer-like liability, disproportionate risk and reparation allocation, and public policies affecting the expansion or limitation of new channels of liability" (Id). "Foreseeability, alone, does not define duty--it merely determines the scope of the duty once it is determined to exist. The injured party must show that a defendant owed not merely a general duty to society but a specific duty to him or her, for without a duty running directly to the injured person there can be no liability in damages, however careless the conduct or foreseeable the harm" (Id.).

Ivy argues that any duty of due diligence ran to Beacon Management, the party with whom it contracted in the consulting agreement, not to Beacon Associates. However, because Beacon Management, the managing member, owed a duty of reasonable care to the company, the reasonable expectations of the contracting parties was that Ivy owed a duty of reasonable care to Beacon Associates. Moreover, there is no danger of proliferation of claims in recognizing a duty of due diligence running in favor of the limited liability company. While a derivative action may potentially be brought by any member, there can be only one recovery in favor of Beacon Associates. Thus, the court concludes that Ivy owed Beacon Associates a duty to investigate the investment manager with reasonable diligence.

"A contracting party may be charged with a separate tort liability arising from a breach of duty distinct from, or in addition to, the breach of contract. A tort may arise from the breach of a legal duty independent of the contract, but merely alleging that the breach of a contract duty arose from a lack of due care will not transform a simple breach of contract into a tort" (***Sommer v Fed. Signal Corp.***, 79 NY2d 540, 551 [1992]). An investment consultant may owe a fiduciary duty of loyalty and care to an investment fund which is independent of the duty which is created by the consulting agreement (***Sergeants Benevolent Ass'n v Renck***, 19 AD3d 107, 111 [1st Dept 2005]). In that circumstance, a negligence action by the fund is not duplicative of its breach of contract claim. In the present case, plaintiffs' claim for breach of contract arises from the administrative services agreement, but their claims for negligence and breach of fiduciary duty are based upon an independent duty of due care arising from Ivy's role as the investment consultant. Moreover, because plaintiffs' negligence claim is not based solely upon the consulting agreement, it is not based solely on acts committed before January 1, 2006.

"In disentangling tort and contract claims, [the court has] considered the nature of the injury, the manner in which the injury occurred and the resulting harm" (***Sommer v Fed. Signal Corp.***, **supra**, 79 NY2d at 552). "[W]here plaintiff is essentially seeking enforcement of the bargain, the action should proceed under a contract theory." While nonfeasance, or failure to perform a duty, was traditionally viewed as a breach of contract, and misfeasance, or defective performance, was viewed as sounding in tort, such labels are not controlling (Id).

In their claim for breach of the administrative services agreement, plaintiffs seek damages in the amount of the value of Beacon's Madoff investment. Thus, plaintiffs do not seek "the benefit of the contractual agreement" but rather tort damages in the form of the harm caused by defendant's conduct (***Camp Kennybrook, Inc. v Kuller***, 214 AD2d 264, 267 [3d Dept 1995]). The court concludes that plaintiffs' claims against Ivy for breach of the administrative services agreements are duplicative of their claims for negligence. Defendant Ivy's motion to dismiss plaintiffs' claims for breach of contract for failure to state a cause of action is **granted**.

A cause of action for aiding and abetting a breach of fiduciary duty requires a showing of a fiduciary duty owed to plaintiff by another, a breach of that duty, defendant's substantial assistance in effecting the breach, together with resulting damages (***Keystone Int'l v Suzuki***, 57 AD3d 205, 208 [1st Dept 2008]). Ivy argues that it did not provide substantial assistance because it did not know that Beacon Management breached its fiduciary duty to Beacon Associates. However, the letter agreement of November 28, 2005 put Ivy on notice of the provision in Beacon Associates' operating agreement prohibiting the investment consultant's fee being paid by the company. Moreover, in view of Ivy's expertise in the securities industry, it may be inferred that it knew that Beacon Management was under a fiduciary duty of diligence and prudence with respect to Beacon Associates' investments. Furthermore, because Ivy was the investment consultant, it may be inferred that it knew that Beacon Management was not performing due diligence with respect to Madoff. Defendant Ivy's motion to dismiss plaintiffs' claim for aiding and abetting a breach of fiduciary duty for failure to state a cause of action is **denied**.

Accounting malpractice contemplates a failure to exercise due care and proof of a material deviation from recognized and accepted professional standards for accountants and auditors (***Friedman v Anderson***, 23 AD3d 163 [1st Dept 2005]). Plaintiff must establish that defendant departed from generally accepted accounting principles and the departure was the proximate cause of plaintiff's injury (***Kristina Denise Enterprises v Arnold***, 41 AD3d 788 [2d Dept 2007]). Giving plaintiffs the benefit of every possible favorable inference, the court must assume that an audit of Beacon Associates' investments conducted pursuant to generally accepted accounting procedures would have uncovered Madoff's fraud.

"To establish a prima facie case of proximate cause, plaintiff must show that defendant's negligence was a substantial cause of the events which produced the injury" (***Maheshwari v New York***, 2 NY3d 288, 295 [2004]). "Where the acts of a third person intervene between the defendant's conduct and the plaintiff's injury, the causal connection is not automatically severed. In such a case, liability turns upon whether the intervening act is a normal and forseeable consequence of the situation created by the defendant's negligence" (Id). On this motion to dismiss, the court must assume that Madoff's criminal conduct was a "normal" and forseeable consequence of defendant's failure to conduct a proper audit. Thus, plaintiffs have sufficiently alleged that Friedberg, Smith's departure from generally accepted auditing procedures was the proximate cause of the loss of Beacon's investment.

The doctrine of in pari delicto is an equitable defense based on agency which bars a plaintiff from recovering where the plaintiff is itself at fault (***Symbol Technologies, Inc. v Deloitte & Touche***, 69 AD3d 191 [2d Dept 2009]). As a general rule, knowledge acquired by an agent acting within the scope of his agency is imputed to the principal, and the principal is bound by such knowledge although the information is never actually communicated to it (***Center v Hampton Affiliates***, 66 NY2d 782, 784 [1985]). Thus, defendant argues that Danziger and Markhoff's knowledge of their own misconduct must be attributed to Beacon Management, and through Beacon Management to Beacon Associates. However, there is an exception to the rule of imputed knowledge when the agent is engaged in a scheme to defraud the principal. The agent cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose. Thus, Danziger and Markhoff cannot be presumed to have disclosed their breaches of fiduciary duty to Beacon Associates. Defendant Friedberg, Smith's motion to dismiss the amended complaint for failure to state a cause of action is **denied**.

An action for professional malpractice must be commenced within three years of the date of accrual of the claim (CPLR § 214[6]). An accounting malpractice claim accrues upon the client's receipt of the accountant's work product since that is the point that a client reasonably relies on the accountant's skill and advice (***Ackerman v Price Waterhouse***, 84 NY2d 535, 541 [1994]). This is the point when all the facts necessary to the cause of action have occurred and an injured party can obtain relief in court (Id). Pursuant to the continuous representation doctrine, the statute of limitations is tolled where there is a mutual understanding between the professional and the client that there is need for further representation on the specific subject matter underlying the malpractice claim (***Williamson v Price Waterhouse***, 9 NY3d 1, 9 [2007]). Where a client enters into annual engagements with an accountant for the provision of separate and discrete audit services for the preparation of year-end financial statements, there is no mutual understanding as to a need for further representation (Id). While there is a continuing professional relationship, there is no continuing representation as to the particular problem that gives rise to the malpractice claim (Id at 11).

Friedberg, Smith's engagement letter dated February 16, 2006 provides, "[Friedberg, Smith] has agreed to provide advice and make recommendations to assist management of [Beacon II] in performing its functions and making decisions." Since defendant has not established that there was no continuing representation with respect to the auditing of Madoff's statements, defendant Friedberg, Smith's motion to dismiss based upon the statute of limitations is **denied**.

CPLR 3211(a)(4) provides that a party may move for judgment dismissing one or more causes of action asserted against him on the ground that there is another action pending between the same parties for the same cause of action in a court of any state or the United States. The court need not dismiss upon this ground but may make such order as justice requires (Id). A court has broad discretion as to the disposition of an action when another action is pending (***Simonetti v Larson***, 44 AD3d 1028 [2d Dept 2007]). The court may dismiss one of the actions where there is a substantial identity of the parties and causes of action (Id). The two actions must be sufficiently similar and the relief sought must be the same or substantially the same. It is not necessary that the precise legal theories presented in the first proceeding also be presented in the second proceeding, provided that both suits arise out of the same subject matter or series of alleged wrongs (Id). See also (***City Line Auto v Citicorp. Leasing***, 45 AD3d 716 [2d Dept 2007]). New York generally follows the first-in-time rule, which provides, as a matter of comity, that the court which has first taken jurisdiction is the one in which the matter should be determined (***L-3 Communications v Safenet***, 45 AD3d 1, 7 [1st Dept 2007]). However, this rule of priority should not be applied in a mechanical way, and special circumstances may warrant deviation (Id).

The court concludes that there is identity of parties because all of the defendants in the present case are also defendants in the federal action. The court notes that the federal consolidated complaint does not contain a claim against Beacon Management for breach of the operating agreement based upon arranging for Beacon Associates to pay Ivy's administrative services fee. However, the court concludes that the actions are sufficiently similar even though this precise legal theory is not alleged in the federal complaint. Additionally, at least two of the federal cases were filed prior to the present action. Accordingly, defendants Beacon Associates Management and Beacon Associates LLC II's motion for a stay pending resolution of the consolidated federal action is **granted**.

Dated______________________ ______________________________

J.S.C.