## **Legal Updates & News**

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## Second Circuit Court of Appeals Ruling May Impact Investment Advisors' Liability in Litigation Involving Failed Investments

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## South Cherry Street, LLC v. Hennessee Group LLC

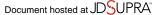
On July 14, 2009, the Second Circuit Court of Appeals issued an important decision in *South Cherry Street, LLC v. Hennessee Group LLC*, 2009 U.S. App. LEXIS 15467 (2d Cir. 2009), that may have broad impact for investment advisors and feeder funds involved in litigation related to Madoff or other Ponzi schemes, failed hedge funds, and the like.

In South Cherry Street, plaintiff (South Cherry Street, LLC, or "South Cherry") entered into an oral agreement with Hennessee Group LLC ("Hennessee"), a hedge fund investment advisory firm, pursuant to which Hennessee would recommend to plaintiff hedge fund investments that passed Hennessee's due diligence process and perform ongoing due diligence on any investments in return for a one percent fee. Thereafter, Hennessee recommended that South Cherry invest in Bayou Accredited ("Bayou"), a fund run by Sam Israel III and Daniel Marino. In reliance on Hennessee's representations and recommendations regarding Bayou, South Cherry did invest in Bayou. Bayou turned out to be a Ponzi scheme, and South Cherry lost its entire investment.

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South Cherry filed suit against Hennessee alleging breach of contract and securities fraud under Section 10(b) of the Securities Exchange Act of 1934 as amended. The complaint alleged that Hennessee had breached the oral agreement with South Cherry to perform due diligence and had violated the securities laws by recklessly failing to uncover the Bayou fraud. Hennessee moved to dismiss both claims. The district court dismissed the breach of contract claim on the ground that the oral agreement was not an enforceable contract and dismissed the securities fraud claim on the ground that the plaintiff had not adequately pled scienter, or intent to defraud. In order to plead scienter, a plaintiff must allege (1) facts creating a strong inference of scienter and (2) that the inference of scienter be at least as compelling as any opposing non-fraudulent or non-reckless intent.



On appeal, the Second Circuit affirmed the district court's decision. The Second Circuit held that the alleged oral agreement regarding Hennessee's "unique due diligence process" was barred by New York's statute of frauds requiring agreements that cannot be completed within one year to be in writing. The Second Circuit also held that the factual allegations in the complaint did not rise to a strong inference of either fraudulent intent or conscious recklessness, and that the inferences advocated by South Cherry were not as compelling as an inference of negligence on the part of Hennessee.

The Second Circuit held that the complaint did not have any facts showing that Hennessee intentionally misrepresented facts about Bayou because South Cherry had not alleged that Hennessee knew that its statements regarding Bayou were false. The Second Circuit noted that federal and state officials did not focus on the Bayou funds until the summer of 2005, following Israel's announcement to investors that the Bayou funds would be liquidated. The Second Circuit held that South Cherry failed to allege that prior to that announcement there were obvious signs of fraud, or that the danger of fraud was so obvious that Hennessee must have been aware of it.

The Second Circuit also held that South Cherry's factual allegations regarding Hennessee's failure to conduct due diligence did not give rise to a strong inference of an intent to defraud. The Second Circuit held that while "it would be plausible to infer that Hennessee Group had been negligent in failing to discover the truth," it "is far less plausible to infer that an industry leader that prides itself on having expertise that is called on by Congress, that emphasizes its thorough due diligence process, that values and advertises its credibility in the industry – and that evaluates 550 funds – would deliberately jeopardize its standing and reliability, and the viability of its business, by recommending to a large segment of its clientele a fund as to which it had made, according to South Cherry, little or no inquiry at all."

Weighing heavily in the court's decision on both the contract claim and securities claim was that at its core, *South Cherry Street* "was a contract case." Essentially, the court determined that the due diligence obligations were, in this case, contractual in nature but the oral contract between the parties was unenforceable. How the court would deal with a case where there was a written contract imposing due diligence requirements has yet to be determined.

Although it was somewhat fact-specific, the *South Cherry Street* ruling is important because it rejected a securities fraud claim against an investment advisor in the context of a Ponzi scheme where the advisor had made specific investment recommendations and had allegedly conducted ongoing due diligence. In an investment environment rife with failing investment vehicles, Ponzi schemes, and other issues related to large-scale investments, *South Cherry Street* is likely to have a broad impact on the liability of advisors, feeder funds, and other similarly situated entities.