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Class Action Suit Against Hedge Fund that Invested in Madoff Feeder Fund Highlights the Standard of Care to which ERISA Fiduciaries are Held

By Christopher Faille

On February 12, 2009, the Pension Fund for Hospital and Health Care Employees (the Fund), filed a complaint against Austin Capital Management Ltd. (Austin) in the United States District Court for the Eastern District of Pennsylvania for millions of dollars of losses due to allegedly improper investments in securities controlled by Bernard L. Madoff and his company. Specifically, the complaint claimed that Austin “directed significant amounts of investment, estimated at present to be \$184 million, into Madoff-related securities, virtually all of which were lost when the Ponzi scheme became known in December 2008.” As a result, the complaint alleged that Austin failed to prudently invest the Fund’s assets, in violation of the Employee Retirement Income Security Act of 1974 (ERISA)

On April 20, 2009, Austin filed an Answer and Affirmative Defenses, asserting that it “acted at all times in conformance with any applicable fiduciary duties, including, without limitation, its duty to act with the care, skill, prudence, and diligence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.” The Answer also denies that class treatment of the plaintiffs’ claims is appropriate. The matter is now before the U.S. Judicial Panel on Multidistrict Litigation (MDL).

Then, on June 12, 2009, Spector Roseman Kodroff & Willis, P.C. (SRKW), a Philadelphia-based law firm, filed a second class action against Austin for more losses due to improper investments in securities controlled by Madoff. This suit, brought on behalf of the Pittsburgh-based Board of Trustees of the Steamfitters Local 449 Retirement Security Fund and

a nationwide class of similar funds, similarly alleged that Austin failed to prudently invest the benefit funds’ assets, in violation of ERISA.

SRKW alleged that Austin was a fiduciary to the class of benefit funds and owed them the duty to manage investments with the highest care. Instead, the complaint alleged, Austin failed to notice the numerous red flags about the Madoff-related securities. These included:

1. the lack of transparency in the operations of Madoff and Madoff Securities, including Madoff’s refusal to disclose his investment strategy;
2. the fact that investment returns of Madoff Securities were abnormally smooth, with very little volatility, including only five months of negative returns in the past 12 years;
3. the inability of other funds, using Madoff’s stated method, to generate returns in any way comparable;
4. the fact that Madoff acted as his own prime broker, while most hedge funds used large banks as their prime brokers;
5. the fact that monthly account statements sent to Madoff investors did not support the returns being supposedly earned; and
6. the fact that Madoff’s auditors consisted of one office in Rockland County, New York, with three employees: one was 78 years old and lived in Florida, and one was a secretary.

The complaint noted that numerous other investment managers did discover the red flags and declined to invest in Madoff-related securities.

These class actions are some of the many that have been brought in recent months against the “feeder funds” that contributed to Madoff’s Ponzi scheme, or funds that invested in such feeder funds. Theodore M. Lieverman, the Partner at SRKW representing the plaintiffs, told The Hedge Fund Law Report that each of the class action complaints are: “[B]ased on an alleged breach of fiduciary duty under ERISA, in that Austin invested the class members’ money in Rye Select, a Tremont fund, without exercising due diligence.”

This line of cases highlights three issues relevant to hedge funds: (1) the question of when an alleged class of plaintiffs bringing suit against a hedge fund will be certified by a court; (2) the standard of care applicable to ERISA fiduciaries; and (3) the standard for consolidation and transfer of MDL cases. The article reviews each of those issues.

Class Action

Under Federal Rule of Civil Procedure (FRCP) 23, a class may be certified only if: (1) the class is so large that joinder of all members is impracticable; (2) there are legal or factual claims in common among class members; (3) the claims and defenses of the named parties are typical of those of the unnamed class members; and (4) the representative parties will fairly and adequately protect the interests of the class.

Courts recently have been vigilant concerning the “typicality” requirement. For example, in December 2008, the United States District Court for the Southern District of Iowa refused to certify 23 proposed statewide consumer fraud

class actions concerning the use of Teflon on non-stick cookware, in part because the complaints of the proposed representatives were inadequately “typical” of the whole class. The plaintiffs’ theory involved the claims that DuPont made for Teflon in a variety of advertising and promotional media over a period of more than forty years. “Because of the variety of circumstances under which each proposed plaintiff undoubtedly purchased and proceeded to use his or her [non-stick cookware] . . . this Court is inclined to agree with DuPont’s position on this issue,” the court said in its decision. *In re Teflon Products Liability Litigation*, MDL No. 1733, CIVIL NO. 4-06-md-01733 (Dec. 5, 2008).

Similarly, Austin may argue that the plaintiffs that invested in it were sufficiently differently situated such that class certification was not warranted. For example, Austin may argue that each plaintiff may have been exposed to different representations or omissions, thus undermining the typicality prong of FRCP 23. Austin may counter, for example, that all representations are merged into its private placement memorandum (PPM), but that will only shift the focus of individual suits to the representations in the PPM, which individual plaintiffs likely will allege were breached.

Theresa L. Davis, a Partner in the Litigation and Dispute Resolution Practice of Katten Muchin Rosenman LLP, noted to The Hedge Fund Law Report: “Many of the recent decisions demonstrate that the types of class action we are seeing arise out of the Madoff matter are going to encounter significant difficulties. Class certification is likely to be challenged if there are significant institutional investors among the purported class members, and depending of course on the specific facts such a challenge may be successful.”

Sophistication

Lynda Grant, a Partner at Cohen Milstein Sellers & Toll PLLC, who has represented employee and pension plaintiffs in many ERISA class actions, expressed skepticism about the prospects of such a challenge. “I represent a lot of sophisticated investors. Sophistication does not mean that you cannot be defrauded. There is nothing strange about the idea that a class consisting of sophisticated investors, including pension funds, through a feeder fund that allegedly failed to exercise due diligence, could be certified, though defendants may certainly raise the issue of ‘sophistication’ during the class certification process.”

Lieverman told The Hedge Fund Law Report that in his view the certification issue is linked to the question of the standard of care. “The defendants might make that argument [about certification], but it is not a very persuasive one. Under ERISA, investment managers are by definition fiduciaries and are bound to a high duty of care to act prudently.”

Avoiding ERISA

Many hedge funds seek to avoid regulation under ERISA by limiting investments by or on behalf of benefit plan investors (for example, ERISA plans, Individual Retirement Accounts, and entities investing on behalf of such plans). A hedge fund manager will not become subject to ERISA so long as participation by benefit plan investors remains below 25 percent of the value of each class of equity interests issued by the funds managed by the manager. See “Impact of Hedge Fund Redemptions Under ERISA,” The Hedge Fund Law Report, Vol. 2, No. 2 (Jan. 15, 2009).

In August 2006, Congress amended ERISA so that certain benefit plans, such as government and foreign pension plans, are no longer included in calculating the amount of plan assets in a fund for purposes of the 25 percent threshold. This has made compliance with the 25 percent rule, and avoidance of ERISA regulation, marginally easier.

According to Gary Howell, a Partner who focuses on ERISA fiduciary issues for Katten Muchin, if a fund were to exceed the 25 percent threshold, the manager would become subject to the prohibited transaction rules. Howell provided the following example: assume that a hedge fund enters into a swap with large Bank X. Bank X or an affiliate is likely to have some kind of service provider relationship with one or more of the plans invested in the fund: it may be a custodian, may manage other assets of the same plan or may be a plan trustee. In any of these cases, Bank X would be a “party of interest” with regard to the plan, and therefore the swap may be prohibited.

A hedge fund that comes within the scope of ERISA could still enter into the swap with Bank X if it could bring the swap within one of the statutory exemptions. However, a far easier approach, where practicable, is to stay below the 25 percent threshold. “Those kinds of considerations drive the decision, generally,” said Howell.

ERISA-Specific Duty of Care

Davis, of Katten Muchin, explained the standard of care applicable to ERISA fiduciaries as follows: “If a hedge fund manager accepts ERISA fiduciary obligations, either contractually or by waiving the 25 percent rule, he would take on fiduciary obligations to the investors that arguably

are heightened from those he otherwise would have, in that hedge fund managers who come within the scope of ERISA are obligated to act in the way that a prudent man ‘acting in a like capacity and familiar with such matters’ would act. A prudent fiduciary test, rather than a prudent man-on-the-street test, so to speak.”

Regardless of the 25 percent test, a hedge fund manager can agree to be subject to ERISA by contract. With respect to Austin, Lieverman told The Hedge Fund Law Report: “Each of the named plaintiffs has a written agreement with the defendant Austin that the latter would be deemed to be a fiduciary under ERISA, so the 25 percent standard is irrelevant to the duty of care that Austin owed the parties.”

The MDL Process

As described above, there are pending lawsuits relating to Austin and its allegedly inadequate due diligence in multiple districts. That is the type of situation addressed by 28 U.S.C. Section 1407(a), which provides that where civil actions involving common questions of fact are pending in different districts, the pre-trial proceedings may be transferred to a single appropriate district for consolidated proceedings. The statute provides that considerations

relevant to a consolidation motion include “the convenience of parties and witnesses and . . . the just and efficient conduct of such actions.”

Lieverman indicated that there was some interest in consolidating the common questions of fact concerning Austin and its Madoff-related losses in New York and Texas. Madoff’s operations were based in Manhattan and Austin is headquartered in Austin, Texas. But Lieverman would argue for venue in Pennsylvania. The first-named plaintiff in the action brought on February 12 is the Pension Fund for Hospital and Health Care Employees - Philadelphia and Vicinity. The other named plaintiff in that action, Henry Nicholas, is an individual resident of Philadelphia.

Fred Burnside, who co-chairs the Class Action Defense Group at Davis Wright Tremaine LLP, spoke to The Hedge Fund Law Report about the MDL process. He said that the factors relevant to a consolidation determination “include finding a forum that doesn’t already have many MDL cases, has at least one related cases pending on its docket, has a judge with some experience handling similar issues, and is generally convenient to many of the parties.”