

# AUDITING DUE DILIGENCE IN LAW AND ETHICS: THE PONZI “FEEDER FUND” CASES

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## ABSTRACT

*Financial accounting is an information conveyance process. When financial auditors issue an opinion in regard to financial statements, the auditors are providing assurance that those financial statements fairly represent the entity, and are prepared in accordance with the relevant standards. If there is a problem with the financial statements for which an unqualified audit opinion has been issued, the auditors may be questioned in regard to their compliance with professional technical and ethical standards that require competency, honesty, and full disclosure. These questions may be asked by the auditors' professional organizations, such as the American Institute of Certified Public Accountants (AICPA), by government regulators who authorize the performance of auditing services, and by the judges and juries of the judicial system. This paper considers how the judiciary, in particular, takes into account auditors' technical and ethical standards when auditors are sued for professional negligence and negligent misrepresentation. This investigation is done within the context of the recent lawsuits against auditors of “feeder funds” that invested with Ponzi scam artists such as Bernard Madoff. This paper concludes that the auditing profession has a “teachable moment” in the wake of the feeder fund failures, and should not overlook this opportunity to upgrade its ethical standards.*

**JEL:** K23; M42; M48

**KEYWORDS:** Auditing, financial disclosure, due diligence, negligent misrepresentation, accountants' liability, professional ethics, Ponzi, feeder funds.

## INTRODUCTION

**F**inancial auditing is a professional discipline that requires both the technical skills and ethics. In the United States, the technical skills include both a thorough understanding of generally accepted accounting principles (GAAP) employed by the audit client, and rigorous application of generally accepted auditing standards (GAAS) in order to ensure that the auditors' opinions are reliable. Auditors must also adhere to rigorous standards of due diligence, honesty and full disclosure in order to ensure that the auditors' opinions are trustworthy.

This paper provides a discussion of skills required of auditors. This paper considers how the judiciary, in particular, takes into account auditors' technical and ethical standards when auditors are sued for professional negligence and negligent misrepresentation. Specifically, we discuss the issue in relationship with the Bernie Madoff fraud case. In the following section the relevant literature and background are provided. The paper continues with a discussion of Ponzi feeder funds. The next section provides a discussion of red flags in Ponzi feeder fund audits. This paper continues with sections on legal and ethical analyses of auditor due diligence. The paper closes with some concluding comments.

## LITERATURE REVIEW AND BACKGROUND

Several systems operate to evaluate and assess financial auditors' skills and ethics. First, financial auditors attempt to self-regulate through organizations such as the American Institute of Certified Public Accountants (AICPA) and affiliated state accounting societies. These organizations monitor member compliance with the AICPA code of professional conduct and related industry-generated

pronouncements. The AICPA maintains a joint ethics enforcement program that investigates complaints about members who may have violated professional standards. When investigators conclude that members have in fact failed to comply with these standards, disciplinary actions ranging from enhanced continuing education requirements to suspension or termination of membership are enforced.

State regulators provide a second tier of oversight. Certified public accountants are licensed by state licensure agencies who require licensees to abide by state laws and regulations designed to make sure that they are performing reliable and ethical services. Unlike the AICPA and state professional societies, whose primary objective is the enhancement and survival of the profession, state regulators are more concerned with protecting the interests of businesses and consumers who rely upon the services of these professionals. Sanctions for violating state accountancy requirements include warnings, fines, and, in more severe cases, suspension or revocation of the accountant's license.

Federal regulators also play a role in the oversight of accounting professionals. The Securities and Exchange Commission (SEC), for example, reserves the right to prohibit an accountant from serving as an auditor (or even as an officer or director) of public corporations. Auditors and other accountants who do not comply with the technical and ethical standards of their profession can be sanctioned by the SEC and temporarily or permanently "disbarred" from practice before the SEC. Similarly, the Internal Revenue Service (IRS) requires accountants to maintain certain ethical standards as a condition of their right to represent taxpayers before the organization.

Federal and state legislators also play an important role in the regulation of the auditing profession. Federal and state laws governing the performance of financial audits are continually reviewed and updated. Most recently, the Sarbanes-Oxley legislation bolstered the financial auditing process by requiring corporate directors and officers to implement more rigorous internal controls, and to certify that the financial information provided to external auditors is accurate and reliable. This legislation, enacted in the wake of the Enron and related scandals, strengthen the role of auditors and provided additional sanctions for misrepresentation and other violations of the public trust.

Finally, the ultimate arbiter of questions about auditors' performance is the judiciary. Accountants whose services may have fallen below technical and ethical standards may find themselves being sued by plaintiffs, such as investors, lenders, and other users of audited financial statements. Allegations of professional negligence (i.e., malpractice), negligent misrepresentation, and fraudulent misrepresentation can result in liability on the part of auditors if the juries and judges of the court system conclude that the charges are factual. Criminal charges can also be brought when accountants engaged in fraud or willful misrepresentation (or, in securities cases and some other cases, gross negligence or recklessness).

After all of these safeguards, it would seem that the accounting profession is subject to sufficient oversight, so that the risk of economic fallout from investor and creditor reliance upon faulty financial statements would be minimized. History, has proven otherwise. In the recent past, the financial crisis that resulted in the failure of many financial institutions, and triggered the collapse of the housing market, was due in part to the willingness of financial auditors to allow faulty financial statements to be issued. Most recently, questions have been raised about the role of financial auditors who approved the financial statements of "feeder funds" that were invested with Ponzi scam operators such as Bernie Madoff.

This paper examines the technical skills employed by financial auditors who audited these feeder funds, and considers whether both the technical and the ethical standards have been met in these cases. This study considers the role of these financial auditors in light of standards enforced by the various oversight bodies. To the extent that those standards have not been met, this paper serves as a critique of the oversight systems. To the extent that those standards did not effectively serve to prevent auditors from approving the faulty financial statements of these feeder funds, this paper also serves as the basis for

recommendations to improve the standards themselves.

The Madoff Ponzi scheme came to light in December 2008. Ionescu (2010) has considered the Madoff system of fraud and its impact on, and implications for, global financial markets (Ionescu, 2010). Similarly, Sinclair and McPherson (2011a; 2011b) have offered analyses in regard to the influence of the Madoff scam on notions of due diligence generally. Others have studied specific “red flags” (e.g., Fuerman, 2009) or clusters of such warning signs (e.g., Gregoriou & Lhabitant, 2009; Benson, 2009) that should have alerted auditors of and advisors to feeder fund dependencies upon Bernie Madoff’s system of carefully controlled information fabrication and flow. To date there has not been an effort to examine the duty of care of Madoff feeder fund auditors in light of both the legal standards as they have been articulated in recent cases, and professional ethical standards.

Here, the Madoff scam is examined from the larger viewpoint of public policy, and also from the perspective of individual victims. In particular, the G. Phillip Stephenson is studied. Mr. Stephenson did not invest directly with Mr. Madoff, but instead invested in a feeder fund that, in turn, placed his funds with Madoff. The role of the auditors of Mr. Stephenson’s feeder fund, as well as feeder funds generally, is then considered, especially in light of the red flags that the feeder fund auditors either did not notice or ignored. The actions (and inactions) of the auditors is viewed in light of both the legal standards of care, and, professional ethical standards of care. The paper concludes with the observation that even if auditors are able to avoid legal liability, it is in their best professional interests to adopt higher ethical standards that would require greater diligence when suspicious circumstances such as those surrounding the Madoff scandal are extant.

## PONZI FEEDER FUNDS

In December 2008 Bernard Madoff revealed that his multi-billion dollar investment firm, Bernard L. Madoff Investment Securities, LLC (BMIS), was a massive fraud (Efrati, Lauricella & Searcey, 2008). Madoff was a prominent and respected member of the investing community, who used his investment company BMIS to engage in a multi-billion dollar fraudulent scheme. Madoff deceived countless investors and professionals, as well as his primary regulators, the Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA”). On December 11, 2008, Madoff was arrested by federal authorities. Madoff, along with BMIS’s accountant and other associates, and on March 12, 2009, Madoff pleaded guilty to securities fraud and related offenses arising out of his scheme. He was eventually sentenced to 150 years in prison.

Madoff’s accountant, David Friehling of Friehling & Horowitz CPAs, P.C., and his chief financial officer, Frank DiPascali, have pleaded guilty to conspiracy to commit securities fraud and related offenses. Irving Picard, the trustee of Madoff’s bankrupt estate, continues to try to claw back assets from members of his family and various investors who over time “redeemed” more from the fraudulent investment fund than they “invested” in the first place. Recently, Picard has begun suing banks, brokers and accounting firms that allegedly failed to detect (or consciously avoided detecting) the true nature of Madoff’s activities.

To facilitate his scheme, Madoff had claimed he utilized a “split-strike conversion strategy” to produce consistently high rates of return on investment. This strategy, described in detail by Markopolos & Casey (2010), supposedly involved buying a basket of securities corresponding to stocks in the S&P 100 Index as well as options to hedge the risk of those securities. Since at least the early 1990s, however, Madoff did not actually engage in any trading activity. Instead, he generated false paper account statements and trading records. If a client asked to withdraw her money, Madoff would pay her with funds invested by other clients. These tactics are the earmarks of what is generally referred to as a “Ponzi” scheme.

Many individuals and institutions that invested with Madoff did so through “feeder funds.” Investors would often become limited partners or account holders who invested in the feeder fund, which would then invest its assets with BMIS. BMIS, in turn, acted as trader, broker, and custodian of all funds and securities in the account and reported results back to the feeder funds. Feeder fund investors could usually make monthly withdrawals of funds, funded either from a separate feeder fund account or from BMIS itself.

Some feeder funds invested most, if not all, of their assets in BMIS. For example, as noted in the in the case of *Stephenson v. Pricewaterhousecoopers, LLC* (2011 U.S. Dist. LEXIS 23244, 2011), the Beacon Fund was a feeder fund that invested approximately 71% of its assets with Madoff. Between 1995 and 2008, Beacon invested approximately \$164 million with Madoff and withdrew approximately \$26 million, leaving a net investment of approximately \$138 million. As alleged in the case of *In Re: Beacon Associates Litigation*, the reported value of the Beacon Fund’s Madoff account in November 2008, just prior to the revelation of Madoff’s fraud, was approximately \$358 million (2010 U.S. Dist. LEXIS 106355, 2010). Similarly, Greenwich Sentry, a limited partnership affiliated with a larger firm known as Fairfield Greenwich (Bermuda) Ltd., invested all of its investors’ funds into BMIS, as also observed in the case of *Stephenson v. Pricewaterhousecoopers*.

G. Philip Stephenson, was an individual who invested on behalf of himself as well as on behalf the revocable living trust he established for his family as part of his estate plan. He eventually lost \$60 million as a result of his investment in Greenwich Sentry, a feeder fund. The following facts, taken from the *Stephenson v. Pricewaterhousecoopers, LLC* lawsuit initiated by Philip Stephenson in January 2009, tell the story of, and serve as an example of, the plight of feeder fund investors.

In February 2008, after expressing interest in Greenwich Sentry, Stephenson received documents about one of Greenwich Sentry’s sister funds, Fairfield Sentry. He was told that analogous documents for Greenwich Sentry were not yet available but that he could expect them to be similar, and that they would be audited by PWC. These documents included a “due diligence questionnaire” that described protections in the funds, including the role played by PWC. One week later, Stephenson received profit analyses for Fairfield Sentry which he was told by FGG would be representative of results he could expect as a limited partner in Greenwich Sentry.

In March 2008, Stephenson received the Greenwich Sentry Limited Partnership Agreement and fund reports showing that Greenwich Sentry earned profits of just under one percent as compared to a multi-percentage point fall in the Down Jones Industrial Average. Stephenson also received the Greenwich Sentry investment prospectus which described the BMIS split strike conversion strategy and explained that the strategy was implemented by through accounts maintained by Greenwich Sentry at BMIS. Stephenson understood that PWC had approved some or all of these documents and would be serving as auditor for Greenwich Sentry. That was critical for Stephenson as an experienced investor who knew the value of strong risk management: he specifically asked the feeder fund representatives whether PWC had identified any issues with Greenwich Sentry and now claims that he never would have invested in the Greenwich Sentry fund if PWC or a firm of equal repute was not auditing the fund.

In April 2008, Stephenson executed a subscription agreement in his individual capacity and deposited \$60 million in Greenwich Sentry accounts. In May 2008, he received the 2006 and 2007 Greenwich Sentry financial statements in which PWC delivered unqualified audit opinions affirming that the statements were prepared in accordance with Generally Accepted Accounting Practices (“GAAP”) and Generally Accepted Accounting Standards (“GAAS”). After receiving those opinions, Stephenson executed a new subscription agreement in his capacity as trustee on June 1, 2008, and transferred his \$60 million limited partnership interest to the Trust.

At first, the Trust's investment appeared to be paying off. By October 31, 2008, Citco Fund Services (Europe) BV and Citco (Canada) Inc., the fund administrator and sub-administrator respectively, had reported that Stephenson's original \$60 million investment was worth \$62,540,565. And by the end of November 2008, the same investment had realized a 6.59% gain at a time when the Dow Jones Industrial Average experienced losses many times that percentage. Of course, as the world now knows, those gains were illusory and Madoff needed money from investors like Stephenson to pay those prescient few who cashed out before the truth came out. Indeed, on December 11, 2008, when Madoff revealed his fraud, Greenwich Sentry refused to withdraw Stephenson's investment and he has still never recovered a cent of his \$60 million.

### FEEDER FUNDS AUDITS: THE RED FLAGS

In many cases, feeder funds were audited by prominent public accounting firms who issued unqualified opinions. That is, the auditors, gave assurance to feeder fund investors that the financial statements of the feeder funds, including balance sheets that provided values of BMIS investments, were a fair representation of the underlying investment portfolios. As it turns out, the BMIS investments were entirely fictitious, and so the feeder fund financial statements, as audited, were equally unreliable.

As noted above, Greenwich Sentry was one of the feeder funds whose financial statements were audited by Pricewaterhousecoopers (PWC). PWC is a prominent firm which provides auditing, accounting, and other advisory services around the world. PWC conducted an annual audit of Greenwich Sentry. For purposes of that audit (and the audit of other BMIS feeder funds), PWC developed an audit plan. As outlined in the *Stephenson* lawsuit, the audit plan proposed that PWC would conduct discussion and enquiry with BMIS in order to obtain an understanding of the key control activities as they relate to the operations, sub-custodian and prime broker functions. The audit plan also indicated that PWC would perform transaction testing on the investment strategy applied by BMIS for the applicable funds. And the audit plan recognized the need to confirm the existence of investments with BMIS and derivative contracts associated with BMIS's split strike conversion strategy.

Among the items examined during a financial audit are the internal controls that serve to safeguard the integrity of the audit client's financial reporting system. In addition, GAAS requirements, including *Statement on Auditing Standard No. 99: Consideration of Fraud in a Financial Statement Audit* (AICPA, 2002), require auditors to investigate "red flags," or signals of possible fraud, when they become aware of them.

In addition to the technical requirements of GAAS, such as *Statement on Auditing Standard No. 99*, auditors are required to comply with the ethical requirements of the *Code of Professional Conduct* promulgated by the AICPA. Rule 201 of that *Code* provides that an AICPA member shall undertake only those professional services that the member or the member's firm can: reasonably expect to be completed with professional competence; exercise due professional care in the performance of professional services; adequately plan and supervise the performance of professional services; and obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed (AICPA, 2010).

In their lawsuits against feeder fund auditors, investors have accused the auditors of violating GAAS. In many cases, these investor-plaintiffs have charged the auditor-defendants with either fraud or gross negligence, in part because these types and levels of culpability, if proven, would qualify as *scienter*, or knowledgeable wrongdoing, as defined under the federal securities laws. If *scienter* is proven, the plaintiffs can expect to recover higher levels of damages from the defendants than would otherwise be the case. But even if *scienter* cannot be proven under federal laws, plaintiffs can look to lesser state law remedies for negligence, including negligent misrepresentation and professional negligence (malpractice).

Feeder fund auditors have been charged with wrongfully overlooking a variety of red flags, including: (1) the centralization and combining of management, trading and reporting functions by the feeder funds with BMIS, minimizing or eliminating any feeder fund controls over these functions; (2) inconsistencies between the reported asset values of the feeder funds, and financial reports filed with the SEC; (3) the extraordinary returns supposedly generated by BMIS; (4) the lack of market response to the supposed large block trades the BMIS claimed to have transacted; and (5) the implausibility that the “over-the-counter” markets could have supported the large hedge transactions reported by BMIS. Each of these is addressed briefly below.

In many cases, Madoff had managed to wrest control of information flow from the feeder funds. BMIS not only had exclusive control of the management of feeder fund assets, but was also the sole executing broker for trades involving the feeder funds as well as for their trading strategies. BMIS was the sole custodian of the feeder funds, and also the sole source of information for their trades and asset values. Details of these arrangements were disclosed in the public documents filed with the SEC by the feeder funds. Still, even though these arrangements were unusual in the industry, and even though documentation of these arrangements was publicly available, they were not treated by auditors as being indicative of an operational risk that required closer scrutiny.

A second red flag alleged against the feeder fund auditors generally, and PWC in particular, is that BMIS reported asset values for feeder funds that in the aggregate exceeded the value of the total assets under BMIS management that BMIS reported to the SEC. PWC, as auditor of several of the major feeder funds, had access to the financial reports of feeder funds whose assets exceeded the value of total assets reported to the SEC. Of course, PWC also had access to the public reports filed with the SEC. PWC either did not analyze this information (despite internal policies requiring that the firm obtain and review regulatory filings in general), or, did analyze the information but choose not to consider the information to be of sufficient concern for purposes of any follow-up investigation as called for by *Statement on Auditing Standard No. 99*.

The third red flag was the inexplicable rate of return offered to BMIS investors. Not only did BMIS provide extraordinary returns, but it purported to do so at a very low risk by exiting the market on quarter-ending days when its so-called split strike conversion strategy indicated that remaining in the market would not have been profitable. As a general rule, many courts have found suspicious quarter-end transactions to be red flags of fraud, but the feeder fund auditors remained unconcerned about these phenomenal occurrences.

The fourth red flag was the observation that BMIS could not have executed its purported strategy to enter and exit its positions *en masse* because, given the massive size of its holdings, these transactions would have caused market volatility that never in fact occurred. That is, market data did not reflect the transactions BMIS reported to make. To the extent that feeder fund auditors expressly or impliedly indicated that they were adept at analyzing market returns, and that they would do so as part of their audit procedures, this market impact would likely have surfaced. Nevertheless, the auditors did not identify the lack of market fluctuation as a red flag.

The fifth red flag is the charge that the over-the-counter investment markets could not support the volume of options BMIS would have had to place in order to execute its purported split-strike conversion policy. To the extent that the feeder fund auditors held themselves out as management, the auditors had the ability to recognize and understand the rationale for significant and unusual business transactions, and to know about counter-party trading. However, these skills were not employed by feeder fund auditors in the pursuit of red flags in the case of BMIS.

## LEGAL ANALYSIS OF AUDITORS' DUE DILIGENCE

There have been several federal lawsuits filed against feeder fund auditors, and each of them has been dismissed. In all of these cases, the presence of audit-significant red flags, including those described above, has comprised the foundation for allegations of fraud or recklessness on the part of the auditors. And in all cases, the courts have determined that as a matter of law the plaintiffs did not meet the legal requirements for maintaining a claim of fraud or recklessness against the feeder fund auditors.

One of the largest feeder funds in the Madoff case was the Beacon Fund. In November 2008 (just prior to the revelation of Madoff's fraud) the reported value of the Beacon Fund's Madoff account was approximately \$358 million. Friedberg Smith & Co. P.C. was the auditor of the Beacon Fund, and after the demise of BMIS in December 2008, Friedberg was sued by Beacon Fund investors who allegedly relied upon the unqualified Beacon Fund audit opinions issued by the auditor. In making their case against Friedberg, the Beacon Fund plaintiff-investors in the case of *In re Beacon Assocs. Litig.* alleged numerous red flags which they claimed should have prompted further inquiry by Friedberg. First, there was no published SAS 70 audit report available for BMIS; an SAS 70 audit report is a widely recognized auditing standard developed by the AICPA and represents that a service organization such as an investment adviser has been the subject of an in-depth audit of their control objectives and control activities. Second, the vast majority of the Beacon Fund was invested in BMIS, increasing risk. Third, Madoff's accounting firm, Friebling & Horowitz, had been telling the AICPA that it did not perform audits for fifteen years, despite serving as Madoff's auditor. Fourth, Madoff ran his own "back office," which entailed that BMIS calculated its own net asset values and prepared its own account statements.

To bolster their case against Friedberg, the Beacon Fund investor-plaintiffs also alleged that many publicly available facts had suggested that Madoff was obviously a fraud, and that many private investors decided Madoff was suspicious after examining the publicly available data. These additional red flags included: Madoff's intense secretiveness; investors' inability to replicate Madoff's results using his claimed strategy; the low correlation of Madoff's performance to the market, despite the fact that his hedging strategy should have closely correlated to overall market performance; the suspiciousness of Madoff's claims to buy a security at its daily high and sell it at its daily low consistently; instances of Madoff's records reflecting a trade of a security at a price outside of the daily reported range for that security; the fact that an insufficient volume of options were traded on certain days to support Madoff's stated strategy; Madoff's decision to forego the standard hedge fund management fee of 1% plus 20% of profits and settle for commissions on trades, possibly to avoid heavier audit requirements; Madoff's stated practice of liquidating all securities at the end of each reporting quarter and investing the proceeds in treasury bills, ensuring that auditors could not verify the existence of Madoff securities for that period; Madoff's lack of a third-party custodian to hold BMIS's securities; Madoff's use of a small, unknown accounting firm; the fact that BMIS audits did not show any customer activity; the fact that key positions at BMIS were staffed by Madoff's family members; and Madoff's use of paper documentation of account activity and trades despite BMIS's supposed technological sophistication.

The Beacon Fund investor-plaintiffs also noted that although government regulators such as the SEC failed to catch Madoff's fraud, numerous private entities who conducted basic due diligence of BMIS readily came to the conclusion that an investment with Madoff was unwise. As early as 2002, Rogerscasey, a domestic registered investment adviser, warned clients away from Madoff feeder funds. In 2005, Harry Markopolos submitted a complaint to the SEC alleging that Madoff was a fraud. Hedge fund adviser Acorn Partners doubted Madoff's bona fides. Many European hedge funds avoided Madoff because he did not pass their due diligence. In 2007, investment manager Akasia advised clients not to invest with Madoff after becoming suspicious of him. In July 2008, Albourne Partners, a London due diligence firm, advised a client to liquidate a \$10 million investment in a Madoff feeder fund. Despite these litanies of red flags and recognizable warning signals, the court in *In re Beacon Assocs. Litig.*

concluded that the investor-plaintiffs failed to show that Friedburg ever became aware of them, and that the red flags were either not so obvious that an auditor must have known of them, or not strong enough to support an inference of recklessness on the part of the auditors.

The ripple effect of the Madoff fiasco impacted auditors of feeder funds, like Beacon, but it also affected sub-feeder funds. Fulvio & Associates LLP was the auditor of FM Multi-Strategy Investment Fund, LP (“MS Fund”), a sub-feeder fund that invested in larger funds such as the Beacon Fund, which in turn funneled money to Madoff. When the Madoff scam came to light, the investors sued, among others, the auditor, in the case of *Wolf Living Trust v. FM Multi-Strategy Inv. Fund, LP* (2010 U.S. Dist. LEXIS 118169, 2010). The investor-plaintiffs alleged that Fulvio conducted inadequate audits and knowingly or recklessly disregarded numerous red flags with regard to the Fund’s investment in Madoff. Given its failures, the investors alleged that Fulvio disseminated false audit reports that it knew would be provided to limited partners and potential investors. The case was dismissed on jurisdictional technicalities, and the court saw no grounds for jurisdiction under federal securities laws.

The Fairfield Greenwich Group was another feeder fund organization whose financial statements were audited without qualification. The investor-plaintiffs in the case of *Anwar v. Fairfield Greenwich, Ltd.* (2010 U.S. Dist. LEXIS 108929, 2010) charged that the auditors, PwC, overlooked an extensive array of so-called “red flags” – ranging from the impossibility of Madoff’s returns to other financial firms refusing to invest with Madoff – that should have alerted the defendants to infirmities in the Fairfield funds. They suggested that PwC and other feeder fund defendants brushed off suspicions aroused by Madoff’s use of an essentially one-person accounting firm for his multi-billion dollar investment business, and by the unblinking acceptance of trade confirmations that were fraudulent on their face.

The *Anwar* investor-plaintiffs were very specific about the failings of PwC to exercise due diligence in their audits of the Fairfield feeder funds. For example, they charged that PwC had originally claimed that it would meet with BMIS to obtain an understanding of the key control activities as they relate to the operations and process over the custodian, sub-custodian, and prime broker functions.. However, it appeared to the plaintiffs that PwC accepted Madoff’s representations without any independent investigation. For example, Madoff stated to PwC that BMIS’s trades were mostly electronic, with records and reconciliation updated daily. But PwC allegedly knew that Madoff did not provide electronic confirmations to the Funds, but instead provided delayed paper records of his trades. The feeder fund investors alleged that had PwC analyzed and tested Madoff’s investment strategy, it would have detected that the strategy could not have functioned as described, and that the returns claimed by Madoff were not achievable. In short, the plaintiffs alleged that if PwC had performed a proper audit, it would have discovered that Madoff did not actually engage in any legitimate trades and that the assets of the Funds did not exist. Despite these detailed allegations and charges, the court in the concluded that the investor-plaintiffs failed to allege facts that give rise to a strong inference of anything more than a neglect to uphold professional auditing standards. As such, the complaints against PwC and several other Fairfield feeder fund defendants in the *Anwar v. Fairfield Greenwich, Ltd.* case were dismissed.

A group of accounting firms was sued in the case of *Saltz v. First Frontiers, LP* (2010 U.S. Dist. LEXIS 136140, 2010), which involved another sub-feeder fund (First Fontiers) that invested in the feeder fund Beacon Associates LLC rather than in BMIS directly. The plaintiff-investors in that case alleged that the auditors aided and abetted the lack of due diligence by First Frontiers by approving inaccurate and false financial performance statements, and that the auditors knew, or should have known, but for their conscious avoidance, that the statements far overstated the value of each investor’s account because they included the value of worthless BLMIS holdings. The plaintiffs also alleged that the auditors had to have known of at least some of the red flags (unless they were egregiously reckless), but took no action to investigate or disclose the red flags. The court, however, concluded that the plaintiffs were not prepared to prove that the auditors actually knew of the red flags that supposedly would have led them to discover

Madoff's fraud, and dismissed the case against the auditors. The more plausible competing inference, for the court, was that these auditors, like others in the industry, did not find the information available to them so disturbing as to merit further investigation.

Another recent case, *In Re J.P. Jeanneret Associates, Inc., et al.*, involved the accounting firm of Margolin, Winer & Evens LLP. (2011 U.S. Dist. LEXIS 9630, 2011). The Margolin firm audited the Income Plus Fund, a feeder fund that enabled individuals, charities, pension funds and retirement accounts, institutions and other entities including other hedge funds to invest with Madoff. Participation in The Income Plus Fund was offered to investors through confidential Offering Memoranda (OM) that were released in 1993 and in 2003. The plaintiff-investors in that case asserted that Margolin had a duty to understand details of Income Plus' investments, and that in so doing the firm was required to do more than rely solely on the procedures it performed. Much of the Income Plus Fund's investment and income information made available to Margolin was based on information from Madoff, and the plaintiffs charged that the Margolin firm should have looked more closely at the Income Plus Fund. In dismissing the case on behalf of the Margolin firm, the court considered the federal securities law claim asserted against the firm to have been a fraud-by-hindsight claim that is often brought against the auditors who happen to have been engaged to audit feeder funds.

The most recent of these dismissals involved G. Philip Stephenson. As noted above, Stephenson sued PWC and several other parties, alleging, among other things, fraud and malpractice on the part of PWC. The initial lawsuit, *Stephenson v. Citco Group Ltd.*, was filed shortly after the Madoff scam came to light, was dismissed in its entirety on March 31, 2010 (700 F. Supp. 2d 599, 2010). Stephenson appealed the dismissal, but the dismissal was upheld on appeal (2011 U.S. Dist. LEXIS 23244, 2011). The courts determined that under established legal precedence, allegations of GAAP or GAAS violations do not, by themselves, establish *scienter* of their own force. The court also concluded that Stephenson was unable to prove that PWC both knew of, and ignored, the alleged red flags.

### ETHICAL ANALYSIS OF AUDITORS' DUE DILIGENCE

All of the dismissals of the lawsuits against feeder fund auditors, described above, involved claims of recklessness (or worse) on the part of the auditors. To the extent that some feeder fund investors decide to press their claims in state courts under a theory of professional negligence, or malpractice, they might be somewhat more successful than have the plaintiffs in these securities laws cases. Nevertheless, these cases have made it clear that the courts are reluctant to impose liability on feeder fund auditors based on legal interpretations of their standard of care in such circumstances.

Whether or not there is legal liability for overlooking the red flags in the Madoff Ponzi scheme, questions can and should be asked about whether or not the auditors of the feeder funds fulfilled their professional ethical duties. In particular, auditors are required to comply with the AICPA *Code of Professional Conduct* (2010). That code includes Rule 201, which requires that auditors exercising due professional care in the performance of professional services, that they adequately plan and supervise the performance of those services, and that they obtain sufficient relevant data to afford a reasonable basis for conclusions in relation to their audits.

To the extent that one or two red flags may have been missed by the feeder fund auditors, the case could be made that the auditors were acting in full compliance with the ethical requirements of their profession. But the cumulative effect of the laundry list of red flags, of which the auditors were either aware or arguably should have been aware, is compelling. And while such notions as do care, adequate planning, insufficient data are difficult to define precisely for purposes of deciding whether an auditor might have acted unethically, the auditing profession is not necessarily well served if it does not consider the long-term impact of the failures in these feeder fund cases. If the auditing profession does not assume

responsibility for upgrading its ethical sense of responsibility in cases where danger signals are so numerous and voluminous, it may find that its usefulness and relevance to the investing public may diminish.

As it happens, there are ethical protocols in place that would be helpful and instructive if the AICPA chooses to come to grips with the ethical implications of the feeder fund failures. Ironically, in November 2008 (approximately one month before the Madoff failure), the AICPA published guidelines for complying with most of the rules of its *Code* (2008). Those guidelines describe an approach that auditors and other accountants can use to evaluate those relationships or circumstances that can impact the due diligence of an auditor, but that are not explicitly addressed by the *Code* itself. Those guidelines require that auditors carefully identify threats to their compliance with the ethics rules, and evaluate the significance of those threats. If the threats are not at an acceptable level, the threats and safeguards approach involves determining whether safeguards are available to eliminate the threats or reduce them to an acceptable level and, if so, applying such safeguards or, if not, avoiding the situation increase the threats. Threats are identified and evaluated both individually and in the aggregate because they can have a cumulative effect on an auditors compliance with the requirements of due diligence.

This type of analysis of the threat of non-compliance with the due diligence requirements (and other professional ethics standards of the auditing profession) was not conducted by the auditors of the feeder funds in the Madoff Ponzi scheme, for two reasons. First, the threats and safeguards guidelines were not published by the AICPA in time to have had an impact on the feeder fund audits. Second, and much more importantly, the AICPA chose not to make its threats and safeguards guidelines authoritative. That is, the AICPA chose to avoid treating these guidelines as anything more than mere suggestions. This, despite the fact that the AICPA was willing to issue fully enforceable, authoritative threats and safeguard guidelines in regard to one specific rule (that is, the independence Rule 101 of the *Code*). Instead, the guidelines for Rules 102 to 505 of the *Code* were explicitly not required, and were published only as a means of assistance to members in their efforts to comply with the actual rules of the AICPA's ethics code.

## CONCLUSION

Lord Moulton famously referred to ethics as “obedience to the unenforceable” (1924). In the case of the feeder fund audits, auditing standards of care that would have required auditors to be alert to, and to respond to, red flags such as those in the Madoff Ponzi scheme, may be unenforceable. The goal of this paper was to consider, through legal research, how the judiciary, takes into account auditors' technical and ethical standards when auditors are sued for professional negligence and negligent misrepresentation. The primary finding of this paper is that that courts have been unwilling to enforce those standards of care in such a way that auditors are held responsible for disregarding any number of danger signs that went into problems in the financial statements of the feeder funds. This finding is limited by the fact that not all of the Madoff-related feeder fund cases have found their way through the courts, and so there is the unlikely possibility that one or more of the courts could change direction in the years ahead.

It would not serve the auditing profession well to hide behind these court decisions. The auditing profession is entirely dependent upon its reputation for credibility, integrity and diligence. That reputation would be enhanced if the auditing profession treated the failures to exercise sufficient care, planning, and data gathering in these cases, as a “teachable moment.” The profession could begin this process very easily, by simply dusting off its own guidelines for managing the risks of noncompliance with its own ethical standards, and making them enforceable. Future research could result in suggestions for how this might be done.

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