

# INSUFFICIENT HEDGE-FUND FRAUD COMPLAINTS AND MISGUIDED MOTIONS TO DISMISS

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*The universe of federal court judgments on motions to dismiss hedge fund fraud complaints is small but growing. This article examines a cross section of recent cases to extract guidance applicable to future litigants. The table of contents below summarizes the individual lessons to be learned from each case or a number of cases, and the text explains these lessons in greater detail, sometimes suggesting alternative strategies that might prove useful in similar cases. The concluding section suggests additional lessons stemming from some of the cases' common themes. Ultimately, this article mines federal fraud cases brought against hedge funds to suggest how plaintiffs may fashion a sufficient hedge fund fraud complaint, and how hedge fund defendants may dismiss an insufficient one.*

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## I. INTRODUCTION

Hedge fund companies litigate for a variety of reasons. Like any company, they litigate disputes with current and former employees, business partners, attorneys, and trademark infringers. They also litigate disputes specific to the hedge fund industry. This article investigates a subset of these disputes specific to hedge funds, particularly those in which hedge funds find themselves defending against governmental agencies or disgruntled investors. However, the purpose of this article is not to identify the variety of charges these plaintiffs may bring, which include fraud, breach of fiduciary duty, negligence, breach of contract, unjust enrichment, and professional malpractice, to name a few. Other works identify these numerous causes of action while citing exemplary cases.<sup>1</sup> This article, by contrast, looks only at fraud cases, the most common type of allegation, with a focus on the nature of pleadings sufficient to withstand a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

In fraud cases, hedge fund companies must address issues distinct from those presented against investment vehicles that, unlike hedge funds, must register under the Investment Company Act.<sup>2</sup> And whereas few cases were brought against hedge fund companies before the new millennium, the number of fraud cases against these companies has recently grown.<sup>3</sup>

Legal scholarship has not yet analyzed the ability of hedge fund companies to dismiss federal fraud cases at the pleading stage. This article is intended to improve courtroom efficiency by providing a roadmap for litigants to assist them in bringing a proper fraud complaint or in determining whether to bring a complaint at all. By the same token, this article's purpose is to provide guidance to hedge fund companies seeking to dismiss meritless fraud suits quickly.

The analysis proceeds in two parts. Section II briefly summarizes the applicable legislation and case law regarding motions to dismiss under Rule 12(b)(6), as well as pleading requirements in fraud cases. This section also notes nuances of the applicable law as it concerns hedge fund defendants. Section III surveys the various types of fraud cases brought against hedge fund companies in federal court, and examines how the pleadings have been analyzed for sufficiency. The section is organized according to the major mistakes made by losing litigants in each case. By

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<sup>1</sup> See, e.g., Howard S. Meyers, *Hedge Fund Liability: Causes of Action against Managers, Advisers*, 241 N.Y. L.J. 4 (2009).

<sup>2</sup> See 15 U.S.C. § 80a-7 (2009) (requiring investment companies to register with the Securities and Exchange Commission).

<sup>3</sup> U.S. Sec. & Exch. Comm'n, Div. of Inv. Mgmt. & Office of Compliance Inspections & Examinations, *Implications of the Growth of Hedge Funds*, 72-75 (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

“mistakes,” this article does not mean to suggest either malpractice on the part of the attorneys or even that an alternative winning strategy was necessarily available, but rather pitfalls future litigants should avoid based on the past cases examined. Section IV concludes the article by summarizing the individual lessons learned and suggesting additional lessons stemming from some of the cases’ common themes. Ultimately, this article mines the universe of federal fraud cases brought against hedge funds to suggest how to fashion a sufficient hedge fund fraud complaint and how to dismiss an insufficient one.

## II. APPLICABLE LAW

On a motion to dismiss under Rule 12(b)(6), courts accept as true the complaint’s factual allegations and draw all reasonable inferences in the plaintiff’s favor.<sup>4</sup> Nonetheless, the plaintiff must allege “enough facts to . . . nudge[ ] [his or her] claims across the line from conceivable to plausible.”<sup>5</sup>

While the federal pleading rules usually require plaintiffs to make only “a short and plain statement” of the claim for relief,<sup>6</sup> Rule 9(b) requires plaintiffs to plead complaints of fraud “with particularity.”<sup>7</sup> In the context of securities fraud complaints, the PSLRA<sup>8</sup> clarifies that Rule 9(b) requires plaintiffs to “‘specify’ each misleading statement[,] . . . set forth the facts ‘on which [a] belief’ that a statement is misleading was ‘formed[,]’ . . . and . . . ‘state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.’”<sup>9</sup> State of mind, or scienter, can be pled by alleging facts either showing motive and opportunity or constituting strong circumstantial evidence of conscious misbehavior or recklessness.<sup>10</sup>

This much is apparent from the first few paragraphs of discussion in any securities fraud case. However, the black letter law on securities fraud pleading

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<sup>4</sup> FED. R. CIV. P. 12(b)(6), Commentary (2009).

<sup>5</sup> *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). *See also* *Ashcroft v. Iqbal*, 129 S.Ct. 1937, 1949 (2009).

<sup>6</sup> FED. R. CIV. P. 8(a) (2009).

<sup>7</sup> FED. R. CIV. P. 9(b) (2009).

<sup>8</sup> Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(b) (2009).

<sup>9</sup> *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (quoting 15 U.S.C. §§ 78u-4(b)(1)-(2) (2009)).

<sup>10</sup> *ATSI Commc’ns v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007). *See also* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 309-10 (2007) (finding that ultimately a complaint sufficiently alleges state of mind or scienter when “a reasonable person would deem the inference of scienter cogent and at least as compelling as any plausible opposing inference one could draw from the facts alleged”).

standards contains several nuances that must be understood before proceeding with the analysis below. First, Rule 9(b)'s and the PSLRA's heightened pleading standards apply only to the facts that the SEC and a private plaintiff must both prove under Rule 10b-5 to win a securities fraud case—a fraudulent act in connection with the purchase of securities and scienter. The heightened pleading standard does not generally apply, however, to additional facts that only a private plaintiff must prove, including transaction causation, reliance upon the misrepresentation or omission, economic loss or damages, and loss causation.<sup>11</sup> Thus, in theory, plaintiffs' allegations must be particular regarding only the materiality and scienter requirements.<sup>12</sup> For the other requirements—transaction causation, reliance, damages, and loss causation—plaintiffs need not allege facts with any particularity, although doing so may help if one wants to establish plausibility rather than mere conceivability.<sup>13</sup>

However, some courts also require heightened pleading for the loss causation element. Notwithstanding the Supreme Court's assumption in *Dura Pharmaceuticals, Inc. v. Broudo* that for loss causation a plaintiff must meet only Rule 8(a)'s pleading standard of fair notice,<sup>14</sup> lower courts interpreting *Dura* are divided on whether loss causation is one of the circumstances of fraud that must meet the heightened pleading requirements of Rule 9(b).<sup>15</sup> In the Second Circuit, for example, unlike in the Northern District of Illinois,<sup>16</sup> plaintiffs must allege “facts sufficient to support an inference that it was defendant's fraud—*rather than other salient factors*—that proximately caused plaintiff's loss.”<sup>17</sup> This requirement allows defendants to provide alternative “salient” loss causation theories, which courts may require a plaintiff to

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<sup>11</sup> *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761, 768 (2008) (outlining the elements of a private cause of action); *cf.* 15 U.S.C. § 78u-4(b) (imposing heightened pleading requirements only to the elements of materiality and scienter).

<sup>12</sup> *See Dura*, 544 U.S. at 345.

<sup>13</sup> *See Stoneridge*, 128 S.Ct. at 768; *cf.* 15 U.S.C. § 78u-4(b).

<sup>14</sup> *Dura*, 544 U.S. at 347.

<sup>15</sup> *See* Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know*, 62 BUS. LAW. 1281, 1341-42 nn.378-79 (2007) (citing myriad cases indicating a circuit split); Madge S. Thorsen, Richard A. Kaplan & Scott Hakala, *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93, 124 (2006) (concluding that “[a]lthough the Court [in *Dura*] did not hold that loss causation must be pled with particularity, it seems evident that particularity is one protection against dismissal. . . . Simply put, if it can be pled, it should be.”).

<sup>16</sup> *See, e.g., Ong v. Sears, Roebuck & Co.*, 459 F. Supp. 2d 729, 743 (N.D. Ill. 2006) (“Defendants have cited no authority suggesting that *Dura* imposes . . . heightened pleading requirements, and this court can locate none. The court thus concludes that Plaintiffs in this case are not required to plead facts showing economic loss or causation.”).

<sup>17</sup> *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 177 (2d Cir. 2005) (emphasis added).

rebut at the 12(b)(6) stage.<sup>18</sup> Thus, just as loss causation has become an issue to be resolved factually with competing experts at the class certification stage in some courts,<sup>19</sup> loss causation is also becoming ripe for resolution on motions to dismiss.

Second, the reach of the “plausibility” standard, enunciated by the Supreme Court in *Bell Atlantic Corporation v. Twombly*<sup>20</sup> and extended in *Ashcroft v. Iqbal* to “all civil actions,”<sup>21</sup> remains largely untested outside the antitrust and qualified immunity contexts of those cases.<sup>22</sup> Creative plaintiffs in the context of securities fraud thus have room to argue what constitutes plausibility with respect to the final four elements of a securities fraud claim not subject to Rule 9(b)’s heightened pleading standard, subject to the court division noted above regarding the element of loss causation.

Third, most fraud suits against hedge funds proceed under SEC Rule 10b-5 promulgated under Section 10(b) of the Securities Exchange Act.<sup>23</sup> But hedge funds, by nature, find themselves defending against a variety of types of 10b-5 fraud suits. One type, for example, involves a claim of market manipulation, which rests not on false statements or omissions, but on deceptive or manipulative acts.<sup>24</sup> In some cases of market manipulation, “the level of specificity required by Rule 9(b) is somewhat relaxed.”<sup>25</sup> Indeed, the variety of types of fraud cases brought against hedge funds under Rule 10b-5, explored below, underlies the complexity of what constitutes a sufficient pleading. Adding to this complexity are fraud cases brought against hedge

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<sup>18</sup> See, e.g., *Catogas v. Cyberonics, Inc.*, 292 F. App’x. 311, 314-17 (5th Cir. 2008) (dismissing the complaint because plaintiffs could not allege facts to rebut defendants’ alternative loss causation theory).

<sup>19</sup> See, e.g., *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 266-67 (5th Cir. 2007).

<sup>20</sup> 550 U.S. 544, 570 (2007).

<sup>21</sup> 129 S.Ct. 1937, 1953 (2009) (requiring *Twombly*’s plausibility standard in a discrimination suit against government officials brought by a Muslim Pakistani pretrial detainee).

<sup>22</sup> For a discussion of the import of *Twombly* and *Iqbal*, see, e.g., Michelle Spiegel, *Ashcroft v. Iqbal: The Question of a Heightened Standard of Pleading in Qualified Immunity Cases*, 4 DUKE J. CONST. L. & PUB. POL’Y SIDEBAR 375 (2009); Kendall W. Hannon, *Much Ado about Twombly? A Study on the Impact of Bell Atlantic Corp. v. Twombly on 12(b)(6) Motions*, 83 NOTRE DAME L. REV. 1811 (2008); J. Douglas Richards, *Three Limitations of Twombly: Antitrust Conspiracy Inferences in a Context of Historical Monopoly*, 82 ST. JOHN’S L. REV. 849 (2008).

<sup>23</sup> Meyers, *supra* note 1, at 4.

<sup>24</sup> *CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807, 821 (S.D.N.Y. 2006).

<sup>25</sup> *Id.* (quoting *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 339 (S.D.N.Y. 1999)).

funds under other laws, such as the Commodities Exchange Act<sup>26</sup> or state common law.<sup>27</sup>

Finally, defendants have two additional arguments for asserting on a 12(b)(6) motion that the plaintiff has failed to state a claim: (1) the bespeaks-caution doctrine; and (2) the statute of limitations defense, each of which has nuances of its own and is discussed later in this article.

In sum, the law in this area is complex. The next section explores how courts have applied these complexities in cases against hedge funds and provides a critical analysis of challenging the sufficiency of pleadings.

### III. CASE STUDIES

The universe of federal fraud cases in which hedge fund defendants have moved to dismiss a complaint under Federal Rule of Civil Procedure 12(b)(6) is small but growing.<sup>28</sup> Hedge funds today face an increasing number of disgruntled investors and regulators. This section analyzes these cases to provide litigants with lessons learned. Each subheading corresponds with the losing litigant's ultimate mistake, and the discussion under some subheadings also recounts specific winning and losing arguments to consider in future similar cases.

#### *A. Plaintiffs' Mistakes*

##### 1. Conclusory Complaints

One way a plaintiff can fail to state a claim under 12(b)(6), as detailed above, is by making legal conclusions without providing enough facts to support the conclusions as plausible. The following four cases illustrate different ways plaintiffs have mistakenly crafted conclusory complaints and how defendant hedge funds have disposed of those complaints with a motion to dismiss.

*a) Alleging alter egos.* In *Cafaro v. HMC*,<sup>29</sup> the plaintiffs alleged that the HMC fund fabricated statements to investors in its monthly account statements by indicating fictitious profits, and that defendant fund Essex-Morgan shared responsibility for the fraud because the common owner of HMC and Essex-Morgan treated the funds as alter egos, as evidenced by the owner's transfer of \$450,000

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<sup>26</sup> 7 U.S.C. §§ 1 *et seq.* (2009).

<sup>27</sup> See, e.g., *CompuDyne*, 453 F. Supp. 2d at 831-32.

<sup>28</sup> A search in Westlaw's "All Federal Courts" database for "hedge fund," "12(b)(6)," and "fraud" returned 152 cases. A vast majority of these cases occurred within the last few years, and this section references several of them to aid in the analysis.

<sup>29</sup> No. 07-2793 (JLL), 2008 WL 4224801 (D.N.J. Sept. 8, 2008).

from Essex-Morgan to HMC.<sup>30</sup> Essex-Morgan moved to dismiss, explaining that the only transfer the owner made was of his own funds, and that the plaintiffs alleged no facts inconsistent with Essex-Morgan's good faith.<sup>31</sup> The court granted the motion and noted that the plaintiffs failed to "specify 'the who, what, when, where, and how'" with respect to the defendant's material misrepresentation or scienter.<sup>32</sup>

b) *Alleging loss causation.* The plaintiff was more specific in *Collier v. Aksys Ltd.*,<sup>33</sup> but failed to state a claim because of his conclusory allegations of loss causation.<sup>34</sup> The defendant Durus funds accumulated 77 percent of Aksys's stock over nine months, which when revealed alongside Durus' intention *not* to control Aksys, caused the stock price to drop before eventually rebounding.<sup>35</sup> The plaintiff, a short seller, claimed that he lost money by covering his short position the day before the press release caused the drop.<sup>36</sup> Had he only waited an extra day! But the plaintiff's failure to hold his short position longer was irrelevant; the court explained that he needed to establish loss causation during the actual short selling period.<sup>37</sup> In an attempt to do so, he asserted that the stock price would have been high from the beginning of the period, as opposed to rising throughout the period, had Durus disclosed its true intent to concentrate ownership.<sup>38</sup> But the court explained that the fund's true intentions, once revealed, in fact caused a precipitous decline, and thus any alleged material misrepresentations or omissions could not have caused the loss.<sup>39</sup> The plaintiff was forced to plead a market manipulation theory, but could do so only conclusory.<sup>40</sup> He pled no facts to indicate "practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."<sup>41</sup> The court criticized the defendants' "apparent blatant disregard for the reporting requirements under the Securities Act of 1934," but

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<sup>30</sup> Mem. of Law in Opp'n to Essex Morgan's Mot. to Dismiss Pursuant to Fed. R. Civ. P. 12(b)(6) at §§ I.A, I.B; *see also Cafaro*, 2008 WL 4224801 (No. 07-2793 (JLL)).

<sup>31</sup> *See Cafaro*, 2008 WL 4224801, at \*8, \*11.

<sup>32</sup> *Id.* at \*7 (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999)).

<sup>33</sup> No. 3:04CV1232(MRK), 2005 WL 1949868 (D. Conn. Aug. 15, 2005).

<sup>34</sup> *Id.* at \*6.

<sup>35</sup> *Id.* at \*4, \*6.

<sup>36</sup> *Id.* at \*3-\*4.

<sup>37</sup> *Id.* at \*13.

<sup>38</sup> *Id.* at \*11-\*12.

<sup>39</sup> *Id.* at \*15.

<sup>40</sup> *Id.* at \*14, \*16.

<sup>41</sup> *Id.* at \*15 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977)).

explained that misrepresentation alone cannot sustain a market manipulation claim under Rule 10b-5.<sup>42</sup>

The plaintiff in *Collier* claimed next that he lost money by covering his short position months after the price had rebounded.<sup>43</sup> The court also dismissed this claim as conclusory, noting that the plaintiff's cover purchases were "far too removed in time to be causally linked" to misrepresentations revealed months earlier.<sup>44</sup> The plaintiff alleged no facts that would allow the court to infer that the changed price was a result of "not the earlier misrepresentation[s], but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."<sup>45</sup>

c) *Alleging material misrepresentation.* The plaintiffs in *Edison Fund v. Cogent Investment Strategies Fund, Ltd.*,<sup>46</sup> by contrast, did not state enough facts for the court to infer even a material misrepresentation.<sup>47</sup> The defendant fund's investment strategy focused on a managed portfolio of insured subprime automobile finance loans.<sup>48</sup> The fund had generally been able to arrange sales of loan portfolios to credit unions to meet the liquidity requirements of its customers.<sup>49</sup> After the market for managed portfolios of subprime automobile finance loans deteriorated, however, the fund was unable to redeem the plaintiffs' investment.<sup>50</sup> The plaintiffs alleged fraud, claiming that the defendant should have concluded, based on its "superior knowledge of credit union practices[,] . . . that the investment yield targets and liquidity representations set forth in the offering memoranda were impossible to achieve."<sup>51</sup> As evidence, the plaintiffs cited letters issued by the National Credit Union Association ("NCUA") in 2001 and 2004 that urged credit unions to perform due diligence and ongoing monitoring of "alternative financing" arrangements such as

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<sup>42</sup> *Id.* at \*16.

<sup>43</sup> *See id.* at \*3.

<sup>44</sup> *Id.* at \*13.

<sup>45</sup> *Id.* at \*10 (quoting *Dura*, 544 U.S. at 343).

<sup>46</sup> 551 F. Supp. 2d 210, 224 (S.D.N.Y. 2008).

<sup>47</sup> However, the plaintiffs were successful in this case with respect to a different fund. *See* discussion *infra* Part III.B.5; *see also* *Lakonia Mgmt. Ltd. v. Meriwether*, 106 F. Supp. 2d 540, 557-58 (S.D.N.Y. 2000) (dismissing a civil RICO claim for failure to allege with particularity material misrepresentations, omissions, or any other deceitful conduct).

<sup>48</sup> *Edison Fund*, 551 F. Supp. 2d at 217.

<sup>49</sup> *Id.* at 218.

<sup>50</sup> *Id.* at 230.

<sup>51</sup> *Id.* at 221.



subprime lending through third-party providers.<sup>52</sup> The court found these letters insufficient to show misrepresentations about whether credit unions provided a viable origination source and secondary market for loans because the letters' accompanying positive statements showed that they "did not serve as a directive to credit unions to stop this type of lending."<sup>53</sup> In short, "the plaintiffs allege[d] no facts to show that . . . the defendants had reason to believe that 'the credit union market was retrenching due to the NCUA's actions.'"<sup>54</sup>

Not only did the plaintiffs provide no basis for concluding that the offering memoranda were fraudulent, they also were adequately warned of risks under the bespeaks-caution doctrine.<sup>55</sup> As the court explained, the offering memoranda "warned investors that the Funds were appropriate only for sophisticated investors and carried risks—in particular, risks of the illiquidity of the investments."<sup>56</sup> Consequently, "in light of the cautionary language, no reasonable investor could have concluded that the risks of the possible illiquidity of the investments and a risk of loss of capital due to a number of factors, including the tightening of the secondary market, did not exist."<sup>57</sup>

*d) Treating discretionary valuations as gospel.* A special sort of conclusory claim was presented in *Fraternity Fund Ltd. v. Beacon Hill Asset Management LLC*.<sup>58</sup> The plaintiffs alleged that the defendant hedge fund managers intentionally inflated the net asset values ("NAVs") of the fund's investment portfolio to prevent existing investors from seeking to redeem their investments and to induce new investors.<sup>59</sup> The funds involved non-exchange-listed securities, whose valuation differed "depending on the model used in the calculations" and "was not a matter of looking up closing prices in the *Wall Street Journal*, but involved the exercise of judgment."<sup>60</sup> The court found the plaintiffs' allegations conclusory, because they did not allege with particularity either "that the models used or the judgments made by [the plaintiffs' experts] were superior to those used or made by [the fund]," or "that the

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<sup>52</sup> *Id.* at 219.

<sup>53</sup> *Id.* at 222.

<sup>54</sup> *Id.* at 223 (quoting First Am. Compl. at ¶ 45, *Edison Fund*, 551 F. Supp. 2d 210 (No. 06 Civ. 4045 (JGK))).

<sup>55</sup> *Id.* at 221.

<sup>56</sup> *Id.* at 223.

<sup>57</sup> *Id.* at 224.

<sup>58</sup> 376 F. Supp. 2d 385 (S.D.N.Y. 2005).

<sup>59</sup> *Id.* at 390-91, 394.

<sup>60</sup> *Id.* at 396 (quoting *Alteram S.A. v. Beacon Hill Asset Mgmt. LLC*, No. 03 Civ. 2387(LAK), 2004 WL 367709, at \*2 n.5 (S.D.N.Y. Feb. 27, 2004)).

alleged differences in valuations were outside the range of what is considered normal in the industry.”<sup>61</sup> For a particular range of dates, however, the plaintiffs did allege facts showing that the fund managers were self-dealing.<sup>62</sup> During this period, the plaintiffs stated sufficient facts to state a claim of fraud based on overstatement of the NAVs, but outside this period the plaintiffs’ allegations were too conclusory to sustain a claim.<sup>63</sup>

In sum, plaintiffs cannot withstand a motion to dismiss under Rule 12(b)(6) by making conclusory claims. The insufficient complaints examined here were conclusory because they averred (1) only that a defendant fund is the alter ego of a different fund against which the plaintiff’s allegations state a claim; (2) market manipulation based only on misrepresentations, but no economic facts indicating loss causation; (3) losses too removed in time from misrepresentations to imply loss causation; (4) material misrepresentations without facts to show any misrepresentations; and (5) abuse of discretion in valuing assets without supporting data or circumstantial evidence.

## 2. Unnecessary Delay

Since the passage of the Sarbanes-Oxley Act, fraud complaints under Rule 10b-5 must be filed within two years of discovering facts constituting the alleged violation.<sup>64</sup> Discovery includes not only actual notice, but also constructive or inquiry notice.<sup>65</sup> A duty of inquiry arises when “storm warnings” would suggest to an investor of ordinary intelligence that she has probably been defrauded.<sup>66</sup>

In *Ennis v. Montemayor*,<sup>67</sup> for example, the plaintiffs’ fraud claim was barred because the plaintiffs failed to investigate the claim within the limitations period, which began running when the hedge fund sent notice of 91-percent losses and an admission of its “failure to adhere to tenets of our basic philosophy.”<sup>68</sup> As the court

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<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 396-97.

<sup>63</sup> *Id.* at 397.

<sup>64</sup> 28 U.S.C. § 1658(b) (2009). Additionally, complaints may be brought within five years of the alleged violation absent this discovery. *Id.*

<sup>65</sup> *GVA Mkt. Neutral Master Ltd. v. Veras Capital Partners Offshore Fund, Ltd.*, 580 F. Supp. 2d 321, 327 (S.D.N.Y. 2008).

<sup>66</sup> *Id.*; see also *In re Merck & Co., Inc. Sec., Derivative, & ERISA Litigation*, 543 F.3d 150, 164 (3d Cir. 2008), *cert. granted* 129 S.Ct. 2432 (May 26, 2009) (No. 08-905) (identifying a circuit split regarding the employment of this test).

<sup>67</sup> 14 F. Supp. 2d 379 (S.D.N.Y. 1998).

<sup>68</sup> *Id.* at 386-87 (emphasis omitted).

explained, this notice constituted sufficient “storm warnings,” and the plaintiffs had “no justifiable reason . . . for . . . delay in bringing suit.”<sup>69</sup>

Application of the statute of limitations was less straightforward in *GVA Market Neutral Master Ltd. v. Veras Capital Partners Offshore Fund, Ltd.*<sup>70</sup> On the one hand, “numerous news articles, press releases, and lawsuits appeared containing the exact allegations of wrongdoing” that the plaintiff alleged in its complaint, and the plaintiff admitted actually suspecting that the defendant hedge fund had engaged in fraudulent market timing and illegal late trading.<sup>71</sup> But the plaintiff claimed that it had performed its inquiry and had been assured by the hedge fund that it had not acted illegally.<sup>72</sup> The court found this argument unconvincing, noting that the fund’s outright denials “do not fulfill [the plaintiff’s] duty of inquiry and were insufficient to toll the running of the statute of limitations.”<sup>73</sup> The outcome might be different in another case, but in *GVA Market* the court found dispositive “the volume and nature of the information available” to the plaintiff, as well as the plaintiff’s sophistication.<sup>74</sup>

### 3. Failure to Do the Math First

Plaintiffs may present well-pleaded and potentially meritorious claims but nevertheless have their case dismissed as premature for failure to sue first for an accounting. Dismissal for prematurity occurs when the investor suing the hedge fund is also a partner in the fund. In *Drenis v. Haligiannis*,<sup>75</sup> limited partners in a hedge fund adequately pled fraudulent conveyance but had their claims dismissed for failure to sue first for an accounting; however, the court recognized that “in recent years the accounting rule has fallen into relative disrepute.”<sup>76</sup> Whether an accounting is required before a partner files suit against a hedge fund depends on the state law being applied.<sup>77</sup>

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<sup>69</sup> *Id.* at 387-88.

<sup>70</sup> 580 F. Supp. 2d at 321.

<sup>71</sup> *Id.* at 325, 329.

<sup>72</sup> *Id.* at 331.

<sup>73</sup> *Id.* at 332.

<sup>74</sup> *Id.*

<sup>75</sup> 452 F. Supp. 2d 418 (S.D.N.Y. 2006).

<sup>76</sup> *Id.* at 432.

<sup>77</sup> *Id.* at 430.

### *B. Defendants' Mistakes*

Thus far this article has explored ways a plaintiff can fail to state a claim under Rule 12(b)(6). But hedge funds invoking Rule 12(b)(6) to dismiss fraud complaints against them can often be unsuccessful. This section discusses these misguided motions to dismiss and, in some cases, draws lessons from the analysis above concerning insufficient complaints to provide alternative strategies that may prove more successful in future similar cases.

#### 1. Debating Facts

*S.E.C. v. Seaforth Meridian, Ltd.*<sup>78</sup> presents the paradigm of a sufficient fraud complaint and of a hedge fund's misguided motion to dismiss. The SEC alleged that the fund's principals misrepresented the fund's strategy and operations in its primary offering document or private placement memorandum ("PPM").<sup>79</sup> To support this allegation, the SEC's complaint detailed the PPM's assurance that the fund's strategy was to achieve "growth of capital and production of income" by purchasing fixed-income bonds and securities of medium to large capitalized companies.<sup>80</sup> The complaint explained that these were misrepresentations, because the fund invested in "two suspect offshore funds with no verifiable history of paying monthly returns, generating growth of capital, or production of income," and furthermore that the defendant "could not furnish any evidence that [these offshore funds] purchased fixed-income bonds or legitimate recognized securit[ies]."<sup>81</sup> The complaint also noted the PPM's commitment to undertake due diligence regarding prospective investments, which the fund must not have performed, because "any real and meaningful due diligence would have shown that the person behind [one of the offshore funds] was actually a recidivist fraudster permanently banned by the FSA."<sup>82</sup> The complaint also discussed the PPM's nondiscretionary revenue sharing plan and an alleged \$600,000 of undisclosed kickbacks to the fund's general partner, which was inconsistent with the plan because the fund's investment "never demonstrated actual income or revenue."<sup>83</sup> These enumerations in the complaint all explained the SEC's first allegation that the fund misrepresented its strategy and operations.

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<sup>78</sup> No. 06-4107-RDR, 2006 WL 3702091 (D. Kan. Nov. 30, 2006).

<sup>79</sup> Compl. at ¶¶ 27-28, *Seaforth Meridian*, 2006 WL 3694864 (No. 06-4107-RDR).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at ¶ 30.

<sup>83</sup> *Id.* at ¶ 29.

Second, the SEC alleged that the fund misrepresented the credentials and roles of its principals in the PPM by (1) touting principal Tucker's experience but failing to disclose that he was sued by the SEC under the name Klion for defrauding investors; (2) explaining the fund's unawareness of pending litigation against its principals although principal Assemi was facing litigation for investment fraud; (3) failing to disclose Assemi's important conflict of interest—that he was a managing director of one of the offshore funds; and (4) touting the involvement of three principals in performing due diligence before investing, when the other two principals in reality deferred to Assemi.<sup>84</sup>

Finally, the SEC alleged that the fund made false reports of positive returns. Specifically, the fund “sent to investors false and misleading monthly account statements and newsletters showing supposed profits and emphasizing the safety of the investors’ principal” although it “had no financial basis for determining the assets or profits” of the fund.<sup>85</sup> Moreover, in addition to the alleged kickbacks, the complaint alleged that the defendants could not or had refused to explain the disappearance of \$13.5 million sent to the offshore funds.<sup>86</sup>

The defendants moved to dismiss, providing 1,500 pages of exhibits, 1,250 of which consisted of tax returns.<sup>87</sup> This monstrous motion only debated the facts, rather than interpreting them for the court or addressing any shortcomings in the complaint. For example, the defendants argued that the SEC's characterization of the \$600,000 as a kickback was “not correct,” and explained how other facts in the PPM indicated that the \$600,000, contrary to the SEC's assertion, was a management fee.<sup>88</sup> The right strategy on a 12(b)(6) motion, however, is not to contradict the alleged facts, but to argue that they do not state a claim. So here the defendants should have argued that the SEC's description of a \$600,000 “kickback” in the face of no returns *actually alleged* nothing more than a typical management fee in the hedge fund industry, and that the SEC failed to allege with particularity any facts, such as those in the PPM, that would indicate fraudulent motive, given that a typical management fee is not enough to provide motive for fraud.<sup>89</sup> The defendants might

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<sup>84</sup> *Id.* at ¶ 31.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at ¶¶ 34-35.

<sup>87</sup> Resp. Br. Opposing Mot. to Dismiss of Assemi, Clyman, and Friedrich at § V(C), *Seaforth Meridian*, 2006 WL 3702091 (No. 06-4107-RDR).

<sup>88</sup> Mem. of Law in Supp. of Clyman's Mot. to Dismiss the Compl. with Prejudice at § 2, *Seaforth Meridian*, 2006 WL 3702091 (No. 06-4107-RDR).

<sup>89</sup> The Southern District of New York is divided on whether management fees alone provide sufficient circumstantial evidence of fraudulent motive. *See Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 621 (S.D.N.Y. 2008) (noting the split and citing cases); *see also Edison Fund v. Cogent Inv. Strategies Fund*, 551 F. Supp. 2d 210, 227 (S.D.N.Y. 2008).

not have been able to avoid other alleged facts showing motive, opportunity, and circumstantial evidence of conscious misbehavior or recklessness, in which case a 12(b)(6) motion was the improper procedure for making their arguments. But at least taking a non-contradictory method of interpretation tied to elements of the offense would have engaged the court in analyzing any deficiencies in the complaint. Instead, the court denied the motion summarily, noting only that “the complaint here clearly reveals that plaintiff has adequately set forth sufficient claims and facts to overcome a motion to dismiss.”<sup>90</sup>

The defendants’ contradictory approach also failed in *CompuDyne Corp. v. Shane*.<sup>91</sup> The plaintiffs alleged that a hedge fund shorted the stock it later purchased in a private investment in public equity (“PIPE”) offering, thereby manipulating the market and reducing the price it paid in the PIPE transaction, despite that the PIPE purchase agreement unequivocally prohibited any trading in CompuDyne stock.<sup>92</sup> The plaintiffs also provided details of the short sales, including dates and prices.<sup>93</sup> The court found that this was enough to state a claim.<sup>94</sup> It began by noting that for market manipulation claims, “the level of specificity required by Rule 9(b) is somewhat relaxed.”<sup>95</sup> The court then had no trouble concluding that the plaintiffs sufficiently alleged a “scheme to defraud Plaintiffs into selling them shares on the PIPE and to manipulate the market in CompuDyne stock by artificially depressing and/or increasing the volatility of CompuDyne stock prior to the pricing of the PIPE.”<sup>96</sup>

The defendants contested that their illegal short selling before the pricing of the PIPE was only “moderate [and thus] could not have negatively affected the market price of CompuDyne stock,” and that their cover of the short sales before agreeing to the PIPE price neutralized any effect of the short selling.<sup>97</sup> In effect, the defendants contested loss causation, but offered neither an alternative salient explanation for the plaintiffs’ losses nor an economic analysis proving the impossibility of causing plaintiffs’ losses (see further discussion about the impossibility defense in section II.B.4 below). Had they done either, they might have been able to credibly assert that the plaintiffs alleged no facts to indicate loss

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<sup>90</sup> *Seaforth Meridian*, 2006 WL 3702091, at \*3.

<sup>91</sup> 453 F. Supp. 2d 807, 834 (S.D.N.Y. 2006).

<sup>92</sup> *Id.* at 821-22, 824.

<sup>93</sup> *Id.* at 815.

<sup>94</sup> *Id.* at 823.

<sup>95</sup> *Id.* at 821.

<sup>96</sup> *Id.* at 828.

<sup>97</sup> *Id.*

causation. We saw above in the *Collier* case, for example, that this approach of challenging the *plaintiffs'* allegations as conclusory with convincing economic evidence was successful in supporting a motion to dismiss. Without such evidence, however, the court found the *defendants'* contentions “conclusory and contrary” to the *plaintiffs'* allegations, and denied the motion to dismiss without further discussion.<sup>98</sup>

## 2. Raising Irrelevancies

Some motions to dismiss do not attempt to debate facts as described above, but nevertheless are summarily dismissed for failure to show any legal deficiency in the complaint. In *S.E.C. v. Lydia Capital, LLC*,<sup>99</sup> the defendant argued “that the Amended Complaint should be dismissed as against him because even if the SEC prevails on the merits, there are no assets of his within the SEC’s reach.”<sup>100</sup> The court denied the motion without further discussion except to note that a fraudulent scheme had been alleged with requisite detail, that the SEC’s inability to reach the defendant’s assets in the UK was relevant only to settlement discussions, and that the SEC would be wise to reconsider accepting the defendant’s settlement offer.<sup>101</sup>

Defendants also failed to note the legal insufficiency of the allegations against them in *S.E.C. v. Colonial Investment Management LLC*.<sup>102</sup> The SEC alleged that the defendants engaged in conduct that violated a previous version of Rule 105. Since the previous version had been superseded, the defendants argued that “the Amended Complaint fail[ed] to allege any violations of Rule 105 in its current form.”<sup>103</sup> But the new version of Rule 105 had actually been broadened to be less favorable to defendants.<sup>104</sup> Thus the court denied the motion to dismiss, finding that a “willingness to violate the prior version of Rule 105 may be some evidence of a willingness to violate the rule in its revised form.”<sup>105</sup> These examples show that courts deny motions to dismiss that present issues wholly irrelevant to the sufficiency of a fraud claim.

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<sup>98</sup> *Id.*

<sup>99</sup> No. 07-10712-RGS, 2008 WL 509136 (D. Mass. Feb. 21, 2008).

<sup>100</sup> *Id.* at \*1.

<sup>101</sup> *Id.* at \*2.

<sup>102</sup> No. 07 Civ. 8849(PKC), 2008 WL 2191764 (S.D.N.Y. May 23, 2008).

<sup>103</sup> *Id.* at \*2.

<sup>104</sup> *Id.* at \*1-\*2. The current rule prohibits all buyers with short positions from purchasing a security in a registered offering. Previously, the prohibition was restricted only to buyers who had covered their short positions. *Id.*

<sup>105</sup> *Id.* at \*4.

### 3. Ignoring Contract Provisions

While the above motions to dismiss failed to challenge the fraud claim's sufficiency, and thus were dismissed summarily, other losing motions to dismiss directly address the fraud claim's sufficiency and manage to engage the court in analysis. For example, the defendants forced the court to more closely analyze the complaint in *Heller v. Goldin Restructuring Fund, L.P.*,<sup>106</sup> in which both sides presented creative arguments regarding the complaint's sufficiency. Ultimately, however, the defendants' fraud defense was doomed by a provision in the offering memorandum.<sup>107</sup>

The plaintiff alleged, among other things, that the defendant hedge fund (1) failed to disclose its ability to raise only \$40 million of the intended \$200 million of capital commitments it needed to invest in the promised diversified portfolio of eight to twelve underperforming middle-market companies; (2) misrepresented that a prominent investor and businessman had committed approximately \$40 million to the fund; (3) misled the plaintiff into the necessity of investing immediately, when the fund would remain open to new capital commitments for another nine to twelve months; and (4) disclosed the fund's undercapitalization only after it had lost over \$400,000 of the plaintiff's capital due to the fund's investment in a single venture.<sup>108</sup>

The defendants moved to dismiss, arguing that the plaintiff failed to sufficiently plead three of the necessary elements of a fraud claim.<sup>109</sup> First, the defendants challenged the misrepresentations' materiality. They argued that the plaintiff showed no facts indicating that "a reasonable investor would have viewed [the misrepresentations] as significantly altering the 'total mix' of information available."<sup>110</sup> Instead, the plaintiff alleged only an oral misrepresentation concerning the fund's targeted \$200 million capitalization and goal of achieving portfolio diversification.<sup>111</sup> But the subscription agreement with the plaintiff, the defendants argued, contractually waived any reliance on oral statements.<sup>112</sup> Oral statements of best-case scenarios were immaterial, because any reasonable plaintiff would have known that he was making a risky, non-diversified investment based on the documents—the only materials a reasonable investor would have relied upon given

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<sup>106</sup> 590 F. Supp. 2d 603, 609 (S.D.N.Y. 2007).

<sup>107</sup> *Id.* at 615.

<sup>108</sup> Compl. for Fed. Sec. Fraud and Breach of Fiduciary Duty at ¶¶ 40, 42, 53, 54, 68, 70, *Heller*, 590 F.Supp.2d 603 (No. 07 CIV. 3704 (RJS)).

<sup>109</sup> *Heller*, 590 F. Supp. 2d at 613.

<sup>110</sup> *Id.* at 614 (citing the test of materiality stated in *S.E.C. v. Mayhew*, 121 F.3d 44, 52 (2d Cir. 1997)).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 614-15.



the contractual waiver. The plaintiffs thus showed no facts to indicate materiality of the oral misrepresentations, or so the defendants argued.

This argument would have carried the day had the subscription agreement actually waived any reliance on oral representations.<sup>113</sup> But the subscription agreement allowed the investor plaintiff to rely not only on the written documents he had been provided, but also on “independent investigations made by the Investor.”<sup>114</sup> Oral representations conveyed to the plaintiff fit within this category, and hence the fund’s best legal argument collapsed.

In an attempt to revive its argument, the fund cited the bespeaks-caution doctrine, which allows a court to nevertheless find a misrepresentation immaterial if a reasonable investor would consider certain offending statements or omissions insignificant in light of all the disclosures made.<sup>115</sup> In essence, the doctrine “is a reformulation of the ‘reasonable investor’ standard of materiality.”<sup>116</sup> The court explained that the bespeaks-caution doctrine may exonerate hedge fund defendants from allegations of fraud due to “failure to disclose the risks generally associated with securities investments.”<sup>117</sup> But the “doctrine does not apply where the specific risk [severe undercapitalization in this case] is apparent and not disclosed.”<sup>118</sup> As the court analogized, given the defendants’ assurances that the plaintiff had far outdistanced the Grand Canyon when actually he was skirting the brink—oral misrepresentations upon which the plaintiff was contractually entitled to rely—the defendants could not disclaim the materiality of these assertions simply by “warn[ing] [their] hiking companion to go slowly.”<sup>119</sup>

Having lost the materiality argument due to the contract provision, the defendants’ remaining challenges to the allegations of scienter also were doomed to fail. Both parties spent much time in their briefs discussing whether the plaintiffs alleged facts showing motive and opportunity or constituting strong circumstantial

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<sup>113</sup> *Id.* (citing *Silva Run Worldwide Ltd. v. Gaming Lottery Corp.*, No. 96 Civ. 3231(RPP), 2001 WL 396521 (S.D.N.Y. Apr. 19, 2001)); *see also* *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1057 (Del. Ch. 2006) (discussing the legal implications of a “clear integration clause”).

<sup>114</sup> *Heller*, 590 F. Supp. 2d at 615 (emphasis omitted).

<sup>115</sup> *Id.* at 617.

<sup>116</sup> *Id.* at 615.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 617-18 (citing *Edison Fund*, 551 F. Supp. 2d at 226).

<sup>119</sup> *Id.* at 618 (quoting *In re Prudential Sec. Inc. Ltd. P’ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996)).

evidence of conscious misbehavior or recklessness.<sup>120</sup> The court considered these arguments carefully, concluding that the plaintiff's "inference of scienter is cogent and *at least as compelling as*" the defendants' opposing inferences, which was all the plaintiff needed to prove.<sup>121</sup> Seemingly fatal to the defendants' argument was the contention that they "were simply seeking to attract investors for their new Fund in perfectly legitimate ways."<sup>122</sup> But as the court had previously found, the defendants' oral misrepresentations were not "legitimate" absent contractual provisions waiving the plaintiff's reliance on them.<sup>123</sup>

Finally, the defendants challenged the plaintiff's allegations of loss causation, but chose only to debate the alleged facts, a strategy which, as described in Section III.B.1 above, is typically unfruitful.<sup>124</sup> Yet the defendants might have missed an opportunity here. The plaintiff contended that his monetary loss was caused by the foreseeable materialization of the concealed risk of undercapitalization, that is, the fund's "subsequent inability to follow through on its investment strategy of obtaining a diverse portfolio of eight to twelve 'distressed' companies," which led to a high-risk, lost investment in only one company.<sup>125</sup> The defendants denied loss causation, classifying the single-venture investment loss as "an intervening event impacting the Fund's ability to achieve its final capital commitment target and its ultimate success."<sup>126</sup> But this classification of the failed initial investment as an intervening act presupposed that the defendants could invest in a diverse portfolio piecemeal, whereas the plaintiff alleged a counterfactual stated objective by the defendants to invest in a diverse portfolio all at once. Hence the defendants only debated the facts here, albeit indirectly, and in fact devoted little space in the briefs to contesting the allegations of loss causation.

A more successful argument regarding loss causation might have explained that the plaintiff provided no facts indicating that "a diverse portfolio of eight to twelve 'distressed' companies" would have lost less money than the single-venture investment in question.<sup>127</sup> In a distressed economy causing most diversified

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<sup>120</sup> See Compl. for Fed. Sec. Fraud and Breach of Fiduciary Duty, *Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603 (S.D.N.Y. 2007) (No. 07-cv-3704 (RWS)); Reply in Supp. of Defs.' Mot. to Dismiss, *Heller*, 590 F. Supp. 2d 603 (No. 07 Civ. 3704 (RJS)).

<sup>121</sup> *Heller*, 590 F. Supp. 2d. at 623 (emphasis in original).

<sup>122</sup> Reply in Supp. of Defs' Mot. to Dismiss, *supra* note 120, at § II.A.

<sup>123</sup> *Heller*, 590 F. Supp. 2d at 623 (finding "most significant" the defendants' behavior, which would have been irrelevant to the analysis had plaintiffs waived reliance on oral representations).

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* at 624; Compl., *supra* note 120, at ¶¶ 5-6.

<sup>126</sup> Reply in Supp. of Defs' Mot. to Dismiss, *supra* note 120, at § II.B.

<sup>127</sup> *Heller*, 590 F. Supp. 2d at 624.

portfolios to decline, the plaintiff might have lost as much or more money *even had the fund been sufficiently capitalized and diversified*. The plaintiff alleged no facts indicating that the fund would have outperformed any of the myriad money-losing funds whose diversifications were broader than the defendants' alleged objective. Stated this way, the defendants might have pointed to the lack of sufficient allegations to show loss causation, and they might have buttressed the point with economic data. Certainly the defendants could have found room in their briefs by removing the previously discussed arguments rendered moot by the faulty contract provision.

A court also denied a motion to dismiss due to an ignored alleged contract provision in *S.E.C. v. Lyon*.<sup>128</sup> The SEC alleged that the defendants engaged in insider trading in violation of the Securities Act. The defendants challenged the sufficiency of the claim, arguing that the SEC alleged no facts to indicate that the defendants were bound by a duty of confidentiality when they took short positions in the PIPE issuers' publicly traded stock.<sup>129</sup> In so arguing, the defendants ignored the SEC's allegations that they had signed confidentiality agreements. Instead they contended that their receipt of documents containing confidentiality clauses in connection with the concerned PIPE offerings did not establish that they were bound by a duty of confidentiality with respect to those offerings.<sup>130</sup> The court found that this was an issue of fact for trial, depending on discovery of possible oral communications and customary practice.<sup>131</sup> Because the SEC was able to point to written documents containing clauses indicating a duty of confidentiality, it had "state[d] with particularity a plausible claim for the existence of such a duty."<sup>132</sup>

#### 4. Failure to Argue Impossibility

In the *Amaranth* cases,<sup>133</sup> a hedge fund faced charges that it had violated the Commodity Exchange Act, by attempting to manipulate the price of natural gas futures contracts in the case brought by the Commodity Futures Trading Commission; and by actually manipulating the price of those contracts in the case brought by private plaintiffs. In both cases, the plaintiffs alleged that the hedge fund, Amaranth, deliberately waited to sell a substantial number of futures on NYMEX in the final minutes before the close of trading, with intent to cause the

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<sup>128</sup> 529 F. Supp. 2d 444 (S.D.N.Y. 2008).

<sup>129</sup> *Id.*

<sup>130</sup> *Id.* at 451-52.

<sup>131</sup> *Id.* at 453.

<sup>132</sup> *Id.*

<sup>133</sup> *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513 (S.D.N.Y. 2008) (civil claim brought by private plaintiffs); *U.S. Commodity Futures Trading Comm'n v. Amaranth Advisors, L.L.C.*, 554 F. Supp. 2d 523 (S.D.N.Y. 2008) (civil claim brought by the CFTC).

price of natural gas futures to decline.<sup>134</sup> Amaranth allegedly did this to profit from its much larger short positions on over-the-counter natural gas swaps on ICE, which uses NYMEX settlement prices of natural gas futures to calculate the price of natural gas swaps.<sup>135</sup>

At issue in both the attempted manipulation and the actual manipulation claims was the fund's intent to manipulate. In both cases, the defendants who performed the alleged manipulative acts spent most of their efforts to dismiss the claim by arguing that the plaintiffs had alleged no facts to show a manipulative intent.<sup>136</sup> Although one court subjected the plaintiff to Federal Rule of Civil Procedure 8(a)'s liberal pleading standard, while the other imposed Rule 9(b)'s heightened pleading standard, both courts rejected the defendants' interpretation of the facts the plaintiffs alleged, finding the required intent to manipulate at least as convincing as the defendants' alternative explanations based on the timing of the orders, the conduct of the traders, and Amaranth's ICE swap holdings.<sup>137</sup>

Amaranth might have argued alternatively that manipulation was impossible. The theory here, were it true, would have been that Amaranth's late trading of futures on NYMEX was so small relative to the natural gas market that it could not possibly have affected prices. In the actual manipulation case, an element of the offense was indeed "an ability to influence market prices."<sup>138</sup> The plaintiffs alleged no such ability, the defendants neglected to point this out, and the court assumed the criterion to be satisfied.<sup>139</sup> Perhaps it was, but defendants of manipulation claims have an opportunity to contest via economic evidence their ability to manipulate the market, or at least to point out that the plaintiffs failed to allege any facts indicating an ability to manipulate.

In the attempted manipulation case, by contrast, the defendants did point out that the plaintiffs failed to allege any facts indicating an ability to manipulate.<sup>140</sup> But in an *attempt* case, factual impossibility is an affirmative defense, not an element of the claim.<sup>141</sup> The defendants could not shift the burden of pleading without citing

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<sup>134</sup> *In re Amaranth*, 587 F. Supp. 2d at 519; *C.F.T.C. v. Amaranth*, 554 F. Supp. 2d at 525-29.

<sup>135</sup> *In re Amaranth*, 587 F. Supp. 2d at 519-25; *C.F.T.C. v. Amaranth*, 554 F. Supp. 2d at 525-29.

<sup>136</sup> *In re Amaranth*, 587 F. Supp. 2d at 539-41; *C.F.T.C. v. Amaranth*, 554 F. Supp. 2d at 532-33.

<sup>137</sup> *In re Amaranth*, 587 F. Supp. 2d at 541; *C.F.T.C. v. Amaranth*, 554 F. Supp. 2d at 533.

<sup>138</sup> *In re Amaranth*, 587 F. Supp. 2d at 530 (quoting *In re Crude Oil Commodity Litig.*, No. 06 Civ. 6677(NRB), 2007 WL 1946553, at \*3 (S.D.N.Y. June 28, 2007)).

<sup>139</sup> *See id.* at 530-31.

<sup>140</sup> Def. Hunter's Mem. of Law in Supp. of Mot. to Dismiss the Compl. at § II, *C.F.T.C. v. Amaranth*, 554 F. Supp. 2d at 523 (No. 07 Civ. 6682 (DC)).

<sup>141</sup> Given that the plaintiffs sufficiently alleged scienter, that is, that the defendants' project as they conceived it was a crime, defendants could argue only factual impossibility and not legal impossibility.

any economic evidence supporting their inability to manipulate the market. In both attempted and actual manipulation cases, then, defendants may potentially find success by arguing the impossibility of price manipulation if they can support the assertion with facts.

### 5. Failure to Stay Current Regarding Risk

In Section II.A.1.c above, we saw that the plaintiff in *Edison Fund* failed to state enough facts for the court to infer a material misrepresentation, primarily because it could not show an apparent risk to the credit union market that the defendant should have known about when it gave optimistic statements regarding investment in the market. But the plaintiff also brought another fraud claim in the same case regarding a different investment, alleging material misrepresentations occurring *after* the NCUA had distributed its “June 2005 risk alert.”<sup>142</sup> The court found that this alert “appeared to require corrective action,” unlike the NCUA’s previous published letters, which only addressed concerns.<sup>143</sup> Hence the defendant should have been on notice that its statements to investors were false concerning the availability of liquidity in the financial institution secondary market to fund redemption requests. The defendant disagreed, contending that the NCUA’s risk alert failed to allege facts “demonstrat[ing] that the representations concerning the financial institution secondary market were false.”<sup>144</sup> The court found this argument unpersuasive, in contrast to its holding in the first claim.<sup>145</sup> In reviewing both claims, the court assumed that the defendant had a duty to keep abreast of the risk it disclaimed in its offering documents. Having failed to stay abreast of the risk and alter its statements to investors accordingly, the defendants were left hopelessly debating the facts about the risk alert the plaintiffs alleged. Hence the court denied the motion to dismiss where the plaintiffs clearly alleged facts, however debatable, to

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Jurisdictions differ on whether factual impossibility is a defense to attempted prohibited acts. *Compare* *People v. Thousand*, 631 N.W.2d 694 (Mich. 2001) (finding a defendant who sent an obscene picture to an undercover policeman guilty of distribution of obscene material to a minor; impossibility not a relevant defense), *with* *Commonwealth v. Johnson*, 167 A. 344 (Pa. 1933) (finding defendant who attempted murder via voodoo not guilty by reason of inherent impossibility). Assuming defendants can convince the court to allow impossibility as a defense, the argument would have to be something like that the traders might have well been practicing voodoo, because given the economic environment, there was no way they could have manipulated prices.

<sup>142</sup> *Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 225 (S.D.N.Y. 2008).

<sup>143</sup> *Id.*

<sup>144</sup> Reply Mem. of Law in Further Supp. of Mot. to Dismiss Am. Compl. at § I.A, *Edison Fund*, 551 F. Supp. 2d 210 (No. 06 Civ. 4045(JGK)).

<sup>145</sup> *Edison Fund*, 551 F. Supp. 2d at 225.

show that the defendants misrepresented the risk of an investment about which the defendants had a duty to stay current.<sup>146</sup>

#### 6. Passing the Blame

A final lesson to be learned by hedge fund defendants is that they cannot insulate themselves from liability by making material misrepresentations through third parties. In *S.E.C. v. Trubuse*,<sup>147</sup> the SEC alleged that the defendant provided, among other things, account statements and newsletters containing material misrepresentations to third parties for distribution to potential investors. The defendant argued that he did not make the statement personally or exercise control over what was said, but this flatly contradicted the facts the SEC alleged.<sup>148</sup> The court ruled summarily that the defendant “cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties.”<sup>149</sup>

### IV. CONCLUSIONS

This article examined the universe of federal judgments on motions to dismiss hedge fund fraud complaints to determine why courts sometimes dismiss fraud complaints against hedge fund companies, and other times reject defendants’ arguments for dismissal under Rule 12(b)(6). Plaintiffs state insufficient claims when they frame their complaints conclusorily, wait too long to file their complaints, and forget to sue for an accounting before bringing their fraud complaint. Defendants misguidedly bring a Rule 12(b)(6) motion when they debate facts, raise irrelevancies, ignore contract provisions, fail to raise an impossibility defense, ignore a failure to stay current regarding risk, or unmeritoriously pass the blame to a third party through which it has acted.

The universe of precedent is small, but this article suggested two emerging themes in the case law. First, although the form of the defendant’s argument in a motion to dismiss should not appear to debate alleged facts, there is indeed room to debate whether the plaintiff has alleged “enough facts to . . . nudge[ ] [his or her] claims across the line from conceivable to plausible.”<sup>150</sup> And sometimes winning this debate means providing additional facts. Defendants should not be shy in providing economic analysis in their briefs supporting motions to dismiss if doing so can show that the plaintiffs allege no facts to support fraud. This method of destroying the

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<sup>146</sup> *Id.* at 234.

<sup>147</sup> 526 F. Supp. 2d 1001 (N.D. Cal. 2007).

<sup>148</sup> *Id.* at 1006-07.

<sup>149</sup> *Id.* at 1007 (quoting *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959-60 (9th Cir. 1996)).

<sup>150</sup> *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

plausibility of plaintiffs' assertions with economic arguments proved successful in *Collier*, for example.<sup>151</sup> By the same rationale, providing economic counterarguments, if available, might prove useful in future cases with issues similar to those in *CompuDyne*<sup>152</sup> and the *Amaranth* cases<sup>153</sup> by showing an inability to manipulate prices; or to those in *Heller*<sup>154</sup> by showing that the fund's advertised investment would have sustained greater or equal losses than did the alleged fraudulent investment.

A second common theme running throughout the cases, related to the first point, is that loss causation is the fuzziest element to prove, with much creative maneuvering available to adept and economically proficient lawyers.<sup>155</sup> In a depressed economy, it may be difficult to determine whether a hedge fund's investments declined due to fraud or instead due to systemic economic forces. Yet hedge fund claims may increase accordingly, on the theory presented in *Edison Fund*, that hedge funds have a duty to update their offering documents amidst economic crises lest investors feel defrauded by the fund's sustained optimism.<sup>156</sup> In these cases it may be all too easy to allege loss causation, especially since loss causation is not subject to Rule 9(b)'s heightened pleading requirements in some courts,<sup>157</sup> just as it was all too easy for plaintiffs to allege exclusionary conduct in antitrust cases before *Twombly*. Plaintiffs should take note before alleging loss causation without any factual basis that as these claims increase and ultimately lose because plaintiffs cannot prove loss causation at trial, courts may increasingly require more specific allegations at the pleading stage as *Twombly* mandated for exclusionary conduct in antitrust cases, *Iqbal* required for discrimination in suits against government officials, and some courts have already begun requiring for loss causation in securities fraud cases.<sup>158</sup> Defendants would be wise to emphasize this point as much as possible on motions to dismiss, and buttress the argument with alternative loss causation theories supported by economic data to destroy the plausibility of plaintiffs' claims.

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<sup>151</sup> See *supra* Section III.A.1.

<sup>152</sup> See *supra* Section III.B.1.

<sup>153</sup> See *supra* Section III.B.4.

<sup>154</sup> See *supra* Section III.B.3.

<sup>155</sup> See, e.g., *Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 623-24 (S.D.N.Y. 2008); *CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807, 826-28 (S.D.N.Y. 2006); *Collier v. Aksys Ltd.*, No. 3:04CV1232(MRK), 2005 WL 1949868, at \*10-\*11 (D. Conn. Aug. 15, 2005).

<sup>156</sup> See *Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 219-22 (S.D.N.Y. 2008).

<sup>157</sup> See *supra* notes 15-16 and accompanying text.

<sup>158</sup> See *supra* notes 14-19 and accompanying text.