

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NASSAU

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CHARLES J. HECHT, derivatively on behalf of
ANDOVER ASSOCIATES LLC I,

APR 01 2009

Plaintiff,

NASSAU COUNTY
COUNTY CLERK'S OFFICE
Index No.: 006110/09

-against-

ANDOVER ASSOCIATES MANAGEMENT CORP.,
IVY ASSET MANAGEMENT CORP.,
IVY ASSET MANAGEMENT LLC,
CITRIN COOPERMAN & CO., LLP,
MARGOLIN, WINER & EVENS LLP,
JOEL DANZIGER and HARRIS MARKHOFF,

DERIVATIVE COMPLAINT

Defendants,

Jury Trial Demanded

-and-

ANDOVER ASSOCIATES LLC I,

Nominal Defendant.
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Plaintiff Charles J. Hecht, a member of Andover Associates LLC I ("Andover LLC"), by his undersigned attorneys, alleges as and for his derivative complaint on behalf of Andover LLC as follows:

NATURE OF THE ACTION

1. This is a derivative suit brought by a non-managing member of Andover LLC, on behalf of Andover LLC, to recover damages caused, *inter alia*, by the defendants' negligence, gross negligence, breach of fiduciary duty and aiding and abetting breach of fiduciary duty in connection with permitting and causing Andover

LLC, and its predecessor-in-interest Andover Associates, L.P. I, formerly a New York limited partnership ("Andover LP"), to invest approximately a quarter of its assets under the personal control of Bernard L. Madoff ("Madoff") through his investment firm, Bernard L. Madoff Investment Securities, LLC. The relationship between Andover LLC and its predecessor-in-interest Andover LP will be set forth in greater detail below.

2. As has been extensively publicized and set forth in greater detail below, Madoff and his firm were perpetrating a Ponzi scheme unprecedented in scale, and any investments made with or through the Madoff firm were fictitious and worthless.

3. As set forth in greater detail below, Andover LLC's managing member (formerly Andover LP's general partner) breached its fiduciary duty and was grossly negligent, and Andover LLC's investment consultant (formerly Andover LP's investment consultant) was negligent, in missing, ignoring, disregarding or failing to understand numerous warning signs, irregularities, inconsistencies and unanswered questions about Madoff and his firm that would have caused a person exercising reasonable care to not invest or maintain the investment with them. These defendants did not properly follow up on these "red flags" in permitting Andover LP and later Andover LLC to entrust its money to, and then maintain its money with, Madoff and his firm.

4. As set forth in greater detail below, Andover LP's auditors were negligent in conducting their annual audits because they failed to comply with Generally Accepted Accounting Standards (GAAS) in that they failed to plan and perform appropriate audit testing which would have identified Madoff's fraud. Andover LP's auditors did not

conduct proper tests in confirming the existence of approximately a quarter of Andover LP's assets and in verifying that orders were properly executed. Andover LP, and then its successor Andover LLC, maintained its investment with Madoff's firm as a direct result of the auditors' negligence and breach of professional duties.

5. As set forth in greater below, the individual defendants aided and abetted the breach of fiduciary duty by Andover LLC's managing member (formerly Andover LP's general partner) by knowingly causing the managing member (formerly the general partner) to abdicate its oversight responsibilities while collecting millions of dollars in management fees.

6. Under the circumstances alleged herein, Andover LLC's managing member and investment consultant (respectively, formerly Andover LP's general partner and investment consultant) breached their duties to Andover LLC (formerly Andover LP) by respectively causing and recommending it to maintain an investment of approximately a quarter of its assets in an account managed by Madoff and his firm. As a direct result of these defendants' abdication of their respective duties, Andover LLC's investment and the equity of its non-managing members was reduced by approximately 24% as of the date that Madoff's Ponzi scheme was revealed.

7. Andover LLC's managing member and investment consultant (formerly Andover LP's general partner and investment consultant) further breached their duties to Andover LLC (formerly Andover LP) by failing to adequately monitor the activities of Madoff and his firm, including the failure to adequately review the confirmation tickets

and monthly account statements that were issued by the Madoff firm for the managed account in which Andover LP and then Andover LLC was invested. Had they done so, these defendants would have seen a number of significant irregularities that would have caused a person exercising reasonable care to withdraw the entire investment.

8. For its purported services in selecting and "monitoring" the investment of approximately a quarter of Andover LLC's assets with a criminal, Andover LLC's managing member (formerly Andover LP's general partner) has received millions of dollars in fees from Andover LP and Andover LLC, as well as 1% of their yearly net profits.

9. The individual defendants, who exclusively control Andover LLC's managing member (formerly Andover LP's general partner), caused and directed that company to ignore its duty to monitor the investment of Andover LLC and its predecessor Andover LP by establishing and adhering to insufficient standards of review.

PARTIES

Plaintiff

10. Plaintiff Charles J. Hecht is an individual who at all relevant times was a member of Andover LLC and its predecessor Andover LP. Plaintiff became a limited partner of Andover LP in 2006 and was converted into a non-managing member of Andover LLC upon Andover LP's reorganization into a limited liability company effective June 2008.

Nominal Defendant

11. Nominal defendant Andover LLC is a New York limited liability company with its principal offices in Westchester County. Andover LLC is the successor-in-interest to Andover LP, a former New York limited partnership. Andover LP became Andover LLC pursuant to a reorganization effective June 2008.

12. As will be discussed in greater detail below, following Andover LP's reorganization into Andover LLC, the entity that had been Andover LP's general partner became Andover LLC's managing member.

13. Prior to its reorganization into a limited liability company, Andover LP conducted its investment activities directly. Following reorganization, Andover LLC conducts its investment activities indirectly by investing all of its assets into its affiliate, non-party Andover Associates (QP) LLC ("Andover QP"), a New York limited liability company through which other entities also invested. At all relevant times, Andover LLC and Andover QP were under common control. At all relevant times, Andover LP and Andover LLC were under common control and had the same entity serving as general partner for the former and then managing member for the latter. Unless the context specifically requires, the term "Andover" shall refer to Andover LP, Andover LLC and Andover QP collectively.

14. As of December 31, 2007, the last date for which audited financial statements are available, Andover LP's assets totaled approximately \$57.7 million. As of December 1, 2008, immediately prior to the Madoff firm's being uncovered as a fraud, approximately 24% of Andover's assets were invested with Madoff and his firm.

Other Defendants

15. Defendant Andover Associates Management Corp. ("Andover Management") is a New York corporation with its principal offices in Westchester County. Andover Management controlled Andover at all relevant times, first as Andover LP's general partner and then as Andover LLC's managing member following Andover LP's reorganization into a limited liability company.

16. Defendant Ivy Asset Management Corp. is a Delaware corporation authorized to do business in New York with its registered offices in Nassau County. Defendant Ivy Asset Management LLC is a Delaware limited liability company with its principal offices in Nassau County. According to the Form ADV filed by Ivy Asset Management LLC with the SEC on or about January 21, 2009, Ivy Asset Management Corp. converted from a Delaware corporation to a Delaware LLC (Ivy Asset Management LLC) on January 1, 2009. At all relevant times, Ivy Asset Management LLC's predecessor Ivy Asset Management Corp. acted as the investment consultant to Andover Management. At all relevant times, both Ivy Asset Management Corp. and Ivy Asset Management LLC were registered as investment advisers under the Investment Advisers Act of 1940, as amended. Ivy Asset Management Corp. and Ivy Asset Management LLC will be collectively referred to as the "Investment Consultant."

17. Andover LP was initially audited by defendant Margolin, Winer & Evens LLP, a New York registered limited liability partnership with its principal offices in Nassau County. Andover LP subsequently changed its auditor to defendant Citrin

Cooperman & Co., LLP, a New York registered limited liability partnership with its principal offices in New York County, which continues to serve as the auditor for Andover LLC. Defendants Margolin, Winer & Evens LLP and Citrin Cooperman & Co., LLP will be collectively referred to as the "Auditors".

18. Defendants Joel Danziger and Harris Markhoff are individuals who at all relevant times personally controlled Andover Management and, together with their immediate families, owned 100% of Andover Management's equity interests. Defendants Danziger and Markhoff are attorneys admitted in New York, and are one of the legal counsel to Andover Management.

JURISDICTION AND VENUE

19. This Court has personal jurisdiction over the defendants pursuant to CPLR §§ 301 and 302(a).

20. Venue is proper in Nassau County pursuant to CPLR § 503 because one or more of the defendants reside in this county.

21. The damages sustained by Andover LLC are far in excess of the \$75,000 monetary threshold for assignment to the Commercial Division of this county.

STANDING

22. Plaintiff has standing to bring this derivative action on behalf of nominal defendant Andover LLC because he was a member of Andover LLC at the time that defendants committed the acts complained of herein, as well as at the time that this suit

was brought. At all relevant times, plaintiff was a limited partner of Andover LP, Andover LLC's predecessor-in-interest.

23. Plaintiff's membership interests in Andover LLC have a fair value well in excess of \$50,000.

24. Plaintiff is not required to give security for Andover LLC's expenses in this action.

DEMAND FUTILITY

25. Andover LLC has been injured by the defendants' misdeeds as they have resulted in the reduction of Andover's assets by approximately 24%, as of the date that Madoff's Ponzi scheme was revealed.

26. At all relevant times, pursuant to the relevant provisions of Andover LP's partnership agreement and Andover LLC's operating agreement, as the case may be, Andover Management was vested with exclusive power to institute and prosecute any legal proceeding in Andover's name.

27. At all relevant times, the relevant provisions of Andover LP's partnership agreement and Andover LLC's operating agreement, as the case may be, made it clear that Andover Management has complete control over Andover's affairs. Andover's limited partners or non-managing members, as the case may be, had and continue to have no part in the management of Andover and have no authority or right to act on behalf of Andover in connection with any matter.

28. Plaintiff is nevertheless excused from making demand upon Andover Management to bring the claims asserted herein because such demand would have been futile.

**Futility as to Claims Against
Andover Management, Danziger and Markhoff**

29. As will be set forth in greater detail below, such demand would have been futile because Andover Management is itself accused of wrongdoing. Andover Management's control persons, defendants Danziger and Markhoff, are themselves accused of wrongdoing as well. Andover Management cannot possibly evaluate in a disinterested, independent and objective manner whether to sue itself and its control persons, and whether doing so would be in the best interest of Andover LLC.

30. As will be set forth in greater detail below, such demand would have been futile because Andover Management is self-interested in Andover's investment with Madoff and his firm. For making the decision to always invest approximately 20-25% of Andover's assets with Madoff and his firm without proper due diligence or monitoring, Andover Management pocketed an annual management fee of 1.5% of Andover's assets plus 1% of the profits of Andover LP and Andover LLC. This amounted to millions of dollars over the life of Andover.

31. Andover Management passed half of its management fee and profit allocation to the Investment Consultant under an agreement between them. The fees kept by Andover Management and the Investment Consultant were nearly pure profit.

32. As will be set forth in greater detail below, such demand would have been futile because Andover Management, together with its control persons, failed to adequately inform themselves or exercise their business judgment in causing and permitting Andover to entrust approximately a quarter of its assets with Madoff and his firm, in that they did not perform their due diligence, ignored a number of warning signs about Madoff and his firm, did not properly monitor this investment, and failed to inform themselves regarding Madoff, his firm and its trading of Andover's managed account to the degree appropriate under the circumstances.

33. As will be set forth in greater detail below, Andover Management's decisions to invest approximately a quarter of Andover's assets with Madoff and his firm, and then to maintain that level of investment, were so egregious that they could not be the product of sound business judgment.

34. Such demand would have been futile notwithstanding Andover Management's recent appointment of an outside law firm as Andover's attorneys. Without impugning their integrity, attorneys retained by Andover Management cannot possibly evaluate in a disinterested, independent and objective manner whether it is in the best interest of Andover to sue the very persons who retained those attorneys and have agreed to pay their legal fees. A decision not to pursue litigation against Andover Management would be tainted by the appearance of impropriety. Even if the outside attorneys were to advise Andover Management of its gross negligence and breach of fiduciary duty, it is unrealistic to believe that Andover Management would consent to sue

itself. Moreover, Andover LLC's members would have no way to recoup their losses if the outside attorneys were unable to conclude their review and analysis prior to the completion of the pending liquidation.

Futility as to Claims Against the Auditors and Investment Consultant

35. As will be described in greater detail below, such demand would have been futile because Andover Management cannot possibly evaluate in a disinterested, independent and objective manner whether to sue the Auditors because the facts supporting the liability of the Auditors are inextricably interconnected with the facts supporting the liability of Andover Management and a claim against the Auditors would expose Andover Management to counterclaim liability.

36. As will be set forth in greater detail below, each of the Auditors violated their duties to Andover by, *inter alia*, failing to employ sufficient skepticism with respect to the information provided to it by Andover Management about Andover's assets. In order to establish each of the Auditors' liability, it is necessary to first establish the nature of the information provided by Andover Management to that Auditor. As will be discussed in greater detail below, Andover Management failed to disclose to each of the Auditors information of which it was or should have been aware that suggested that the operation of Madoff and his firm was fraudulent and that the confirmation tickets and monthly account statements generated by Madoff's firm were fictitious. Accordingly, it would be futile to demand that Andover Management pursue litigation against the either

of the Auditors because doing so would reveal Andover Management's own liability and expose Andover Management to each Auditor's counterclaims.

37. Similarly, the facts supporting Andover LLC's claim against the Investment Consultant are inextricably interconnected with the facts supporting the liability of Andover Management. The decision to place Andover's assets with Madoff and his firm was made in concert by Andover Management and the Investment Consultant. A claim against the Investment Consultant would expose the extent of Andover Management's gross negligence and breach of fiduciary duty in permitting and causing first Andover LP and then Andover LLC through Andover QP to entrust approximately a quarter of its assets to Madoff's criminal Ponzi scheme, failing to perform due diligence, ignoring numerous warning signs regarding the legitimacy of Madoff and his firm, and failing to properly monitor this investment of approximately a quarter of Andover's assets.

BACKGROUND

Andover's Offering Memoranda

38. At all relevant times, Andover LP continually offered limited partnership interests to qualified investors, such as plaintiff, through a confidential offering memorandum dated August 9, 2004 (the "Old Offering Memorandum"). Under the Old Offering Memorandum, the minimum initial purchase was \$150,000.

39. Following Andover LP's reorganization into a limited liability company, Andover LLC continually offered membership interests to qualified investors through a confidential offering memorandum dated June 2, 2008 (the "New Offering

Memorandum"). Under the New Offering Memorandum, the minimum initial purchase was \$250,000.

40. The New Offering Memorandum disclosed that Andover LLC's investment and trading activities were conducted through Andover QP, its affiliated investment fund. Andover LLC and Andover QP shared the same management and investment consultant. Andover LLC invested all of its assets into Andover QP, which in turn entrusted Madoff and his firm with approximately a quarter of Andover's assets. Prior to reorganization, Andover LP had been directly invested with Madoff and his firm.

41. Both the Old Offering Memorandum and the New Offering Memorandum disclosed that Andover Management was controlled exclusively by Danziger and Markhoff, and that all of Andover Management's equity was owned by Danziger, Markhoff and their families.

Madoff's Ponzi Scheme

42. Bernard L. Madoff was the founder, sole member and principal of Bernard L. Madoff Investment Securities, LLC. The Madoff firm was a registered broker-dealer and registered with the SEC as an investment adviser in 2006. It also engaged in market making and proprietary trading.

43. From at least as early as the 1990s, Madoff and his firm perpetrated a criminal Ponzi scheme by soliciting and then purporting to manage billions of dollars under false pretenses. Madoff promised to invest the investors' funds according to a specific strategy. In reality, he did not invest these funds and misappropriated them for his personal use.

44. The Madoff firm sent its clients, including Andover, paper confirmation tickets and monthly statements. These documents purportedly evidenced the transactions executed in Andover's managed account.

45. At all relevant times, these documents were wholly fictitious as Madoff and his firm did not actually purchase any of the securities referenced in the confirmation tickets and monthly statements.

46. On December 10, 2008, Madoff confessed to certain of his senior employees that his investment advisory business was a fraud. Media reports indicate that Madoff stated he was "finished," that he had "absolutely nothing," that "it's all just one big lie," and that his business was "basically a giant Ponzi scheme." Madoff reportedly explained that he had for years been paying returns to his firm's investors from the principal received from newer investors. He reportedly confessed that his firm had been insolvent for years, and reportedly estimated that the losses from his fraud were in excess of \$50 billion.

47. On December 11, 2008, the US Attorney for the Southern District of New York charged Madoff with eleven criminal counts including securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of money laundering, making false statements, perjury, making a false SEC filing and theft from an employee benefit plan. Additionally, a separate SEC civil proceeding brought on that date charged Madoff with various securities law violations.

48. Madoff agreed to the facts of the SEC civil proceeding on February 8, 2009 and pleaded guilty to all eleven criminal counts on March 12, 2009.

Undertakings by Andover Management and Investment Consultant

49. Andover Management directed the business operations and affairs of Andover, and made all allocation and reallocation decisions concerning Andover's assets. *See* Old Offering Memorandum at 1, 12; New Offering Memorandum at 1, 12.

50. Andover's assets were allocated among independent investment managers at Andover Management's discretion, following consultation with the Investment Consultant. *See* Old Offering Memorandum at 3, 12; New Offering Memorandum at 3, 12.

51. Under the Old Offering Memorandum, Andover's assets were allocated among five managers, each of which invested the assets allocated to it through an independent investment pool. *See* Old Offering Memorandum at 14. The New Offering Memorandum indicated that, as of June 2008, Andover utilized eight managers, seven of which invested the assets allocated to them through separate investment pools and one of whom invested the assets allocated to it through a managed discretionary account. *See* New Offering Memorandum at 12.

52. Unbeknownst to the limited partners of Andover LP and the non-managing members of Andover LLC, the sole manager having discretionary trading authority over this account turned out to be Madoff and his firm, which managed approximately a quarter of Andover's assets (the "Manager"). Prior to Andover's reorganization from a limited partnership into a limited liability company, the Manager was one of the five managers utilized by Andover Management to manage Andover LP's assets.

53. Andover Management selected Madoff and his firm as an investment manager notwithstanding the myriad "red flags" which should have alerted it not to set up and maintain a managed account exclusively controlled by Madoff and his firm.

54. In addition to selecting Madoff and his firm, Andover Management, together with the Investment Consultant, undertook to monitor the Manager's "adherence to their stated investment strategies" using both "quantitative and qualitative" criteria "including analyses of: type of trading program; risk control; duration and speed of recovery from drawdowns; experience; organizational infrastructure; and degree of correlation with traditional investments such as stocks and bonds." *See* Old Offering Memorandum at 12; New Offering Memorandum at 11.

55. Andover Management and the Investment Consultant did not properly monitor the Manager's adherence to its stated investment strategy. Had they done so, they would have discovered serious inconsistencies upon receiving the confirmation tickets and monthly account statements from the Madoff firm for Andover's account. Specifically, they would have discovered that a significant portion of the Manager's purported securities purchases and sales were outside those individual securities' trading range for that day.

56. This discovery would have caused Andover Management and the Investment Consultant to ask for and obtain evidentiary support for these trades, including i) the time of order entry, ii) time of order execution, iii) where the order was executed, and iv) if the counterparty was someone other than the Madoff firm, the

identity of the counterparty and the underlying documentation necessary to support these trades. Had there been documentation evidencing these trades, Andover Management would as Andover's fiduciary have had a claim against the Madoff firm for the difference between the trade prices reported in the confirmation tickets and monthly statements and the prices at which those trades should have been executed. If there were no such documentation, Andover Management and the Investment Consultant would have been put on notice that a substantial portion of the Manager's purported trades were fictitious. In any event, in the absence of gross negligence, Andover Management and the Investment Consultant should have immediately withdrawn Andover's assets from the Manager until it could properly substantiate the existence of its prior trades.

57. In order to fulfill its fiduciary and contractual duties, Andover Management and the Investment Consultant would need to know at what times of day the Madoff firm purported to order and execute Andover's trades, as this information is necessary to check whether these trades were executed at the best available price. However, Madoff and his firm would have been unable to provide them with this information as its trades were entirely fictitious. The Manager's inability to provide this data would have been a sure sign of fraudulent activity.

Compensation of Andover Management and Investment Consultant

58. In consideration for its responsibility to, *inter alia*, vet suitable managers and conduct due diligence and continuous monitoring to avoid fraud and other unacceptable investment risks, Andover Management charged a monthly management fee

of 0.125% (1.5% per annum) of the value of the capital accounts of each of Andover LLC's members or Andover LP's limited partners, as the case may be. Andover Management also received 1% of the annual profits of Andover LP and Andover LLC. This amounted to millions of dollars over the life of Andover.

59. Since Andover's inception, Andover Management turned over on a continuous basis approximately 24% of Andover's assets to the Manager in complete disregard of the ever-growing array of "red flags" that the Manager was operating a fraudulent scheme.

60. Pursuant to an agreement between Andover Management and the Investment Consultant, Andover Management paid one-half of its management fee and profit allocations to the Investment Consultant.

61. As of December 31, 2007, the last date for which audited financial statements are available, Andover LP had approximately \$57.7 million under management, meaning that Andover Management received approximately \$865,500 in management fees for 2007 alone, of which one-half (approximately \$432,750) was paid to the Investment Consultant. In addition to its 1.5% annual management fee, Andover Management would have also received 1% of the profits of Andover LP and Andover LLC in years during which these entities were profitable. After paying off the Investment Consultant, the fees collected by Andover Management ended up in the pockets of Danziger, Markhoff and members of their families.

Duties of Andover Management

62. Because of its position as the control person of Andover and as the general partner of a limited partnership and then a managing member of a limited liability company, Andover Management owed a fiduciary duty to the limited partners of Andover LP and the non-managing members of Andover LLC, as the case may be, as well as a duty of undivided loyalty to the interests of Andover LP and then Andover LLC.

63. Danziger and Markhoff together own 100% of Andover Management's voting stock. Andover Management is wholly owned by Danziger, Markhoff, and their immediate families.

Duties of Investment Consultant

64. The Investment Consultant advised Andover Management on behalf of Andover, pursuant to a contract between the Investment Consultant and Andover Management and between the Investment Consultant and Andover, imposing certain responsibilities upon the Investment Consultant.

65. The Investment Consultant owed Andover Management, and through it to Andover, that duty of care that would be afforded by a reasonably prudent investment consultant under similar circumstances.

Duties of Auditors

66. Andover Management retained the Auditors to audit the financial statements of Andover in accordance with GAAS and to issue an opinion on whether their financial statements were presented in conformity with Generally Accepted

Accounting Principles ("GAAP"). As of the date of this Complaint, the current Auditor has not yet completed its audit of Andover LLC for the year ending December 31, 2008. Accordingly, all financial statements referred to in this Complaint are those of Andover LLC's predecessor-in-interest, Andover LP.

67. Each year the Auditors furnished the audited financial statements of Andover LP to Andover Management together with an unqualified Independent Auditor's Report.

68. Each year, the unqualified Independent Auditor's Report stated that the Auditor in question had audited the financial statements in accordance with GAAS, that the financial statements conformed with GAAP, and that the financial statements presented fairly, in all material respects, the financial position of Andover LP. For example, the Independent Auditor's Report for the financial statements of Andover LP for the year ended December 31, 2007 stated that

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate under the circumstances....An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [Andover

LP] as of December 31, 2007, and the changes in its net assets and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Additionally, the Auditors are subject to regulation by the American Institute of Certified Public Accountants (the "AICPA"), of which each of the Auditors is a member.

69. The audited financial statements of Andover LP were furnished to Andover Management with the knowledge and intention that Andover Management in turn would distribute them to Andover's limited partners or non-managing members, as the case may be, and with the knowledge and intention that the audited financial statements would be relied upon by Andover Management and Andover's limited partners and/or other members.

70. The AICPA has set forth its requirements for compliance with GAAS in its Codification of Statements on Auditing Standards (the "AU"), which specify that "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." AU § 110.02. In so doing, "the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." AU § 150.02. Once it understands the entity and its environment and designed appropriate audit procedures, "the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." *Id.*

71. One of the principal standards of GAAS is that "the auditor must exercise due professional care in the performance of the audit and the preparation of the report." AU § 150.02. Amplifying on that standard, GAAS specifies that "due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence." AU § 230.07 (emphasis in original).

72. An auditor's professional skepticism is particularly critical when assessing the possibility of fraud. GAAS notes that "because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud....The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest." AU § 316.13.

73. The auditor's responsibility to exercise professional skepticism extends to information obtained from independent third parties like brokers and securities custodians. GAAS notes that "there may be circumstances (such as for significant,

unusual year-end transactions that have a material effect on the financial statements or where the [independent third party] respondent is the custodian of a material amount of the audited entity's assets) in which the auditor should exercise a heightened degree of professional skepticism relative to these factors about the respondent. In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and appropriate audit evidence." AU § 330.27.

74. The specific requirements of GAAS applicable to investment companies such as Andover are set forth in the AICPA's Audit and Accounting Guide for Investment Companies, including Chapter 2 as to audits of investment accounts and Chapter 5 as to audits of investment companies with complex capital structures.

75. Under the applicable requirements, the Auditors were responsible for using due professional care and judgment to, *inter alia*:

- a) evaluate and determine the adequacy of arrangements for custody of assets, including receiving adequate assurances that there are proper controls over the custody of assets held by others;
- b) confirm the existence, custody and value of portfolio securities both at year end and selected interim dates;
- c) test an appropriate sample of portfolio transactions for proper authorization, extensions, trade dates and reasonableness of transaction pricing;

- d) test and evaluate calculations of income, gains and losses from securities transactions;
- e) evaluate compliance with investment strategies; and
- f) assess additional factors, including non-financial factors, which may have an impact on internal controls and the presentation of financial position and results.

The Media and Industry Insiders had Raised a Number of Suspicions about Madoff and his Firm

76. Even before the Old Offering Memorandum was first circulated in 2004, a number of persons had already begun to express serious doubts regarding Madoff and his firm.

77. In June 2000, Credit Suisse advised its customers to pull their investments out of Madoff because it could not understand how he made money. See Elena Logutenkova and Ben Holland, *Saint Ossie Resisted Madoff as Credit Suisse Man Savior for UBS*, Bloomberg.com (Feb. 27, 2009) <http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=adL53F7_C9M0>.

78. In May 2001, the trade media raised serious concerns about the legitimacy of Madoff and his firm:

...[M]ost of those who are aware of Madoff's status in the hedge fund world are baffled by the way the firm has obtained such consistent, nonvolatile returns month after month and year after year.... Those who question the consistency of the returns...include current and former traders, other money managers, consultants, quantitative analysts and fund-of-funds executives, many of whom are familiar with the so-called split-strike conversion strategy used to manage the assets.... They noted that others who use or have used the strategy...are known to have had nowhere near the same degree of success.... Skeptics who express

a mixture of amazement, fascination and curiosity about the program wonder, first, about the relative complete lack of volatility in the reported monthly returns. But among other things, they also marvel at the seemingly astonishing ability to time the market and move to cash in the underlying securities before market conditions turn negative; and the related ability to buy and sell the underlying stocks without noticeably affecting the market. In addition, experts ask why no one has been able to duplicate similar returns using the strategy and why other firms on Wall Street haven't become aware of the fund and its strategy and traded against it, as has happened so often in other cases...

See Michael Ocrant, *Madoff tops charts; skeptics ask how*, MAR/HEDGE, May 2001, 1-3.

79. In May 2001, these concerns were amplified by the mainstream media:

Still, some on Wall Street remain skeptical about how Madoff achieves such stunning double-digit returns using options alone. The recent MAR Hedge report, for example, cited more than a dozen hedge fund professionals, including current and former Madoff traders, who questioned why no one had been able to duplicate Madoff's returns using this strategy. Likewise, three option strategists at major investment banks told Barron's they couldn't understand how Madoff churns out such numbers. Adds a former investor: "Anybody who's a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naive."

See Erin A. Arvedlund, *Don't Ask, Don't Tell*, BARRON'S, May 7, 2001.

80. In early 2003, after conducting routine due diligence, Société Générale put Madoff and his firm on its internal blacklist, forbidding its investment bank from doing business with him and strongly discouraging its clients from investing with him.

81. The "red flags at Mr. Madoff's firm were so obvious, said one banker with direct knowledge of the case, that Société Générale 'didn't hesitate. It was very strange.'"

See Nelson D. Schwartz, *European Banks Tally Losses Linked to Fraud*, NEW YORK TIMES, December 16, 2008.

82. A number of smaller investment advisers such as Acorn Partners and Aksia also advised their clients to avoid Madoff because of their concerns about the number of red flags surrounding him.

83. Andover Management and the Investment Consultant should have known of these concerns. At a very minimum, they should have been aware of the concerns raised by MAR/Hedge and Barron's about Madoff and his firm, into which they caused Andover to commit approximately a quarter of its assets.

DEFENDANTS' BREACH OF DUTY

Andover Management and the Investment Consultant breached their Duties to Andover

84. Andover Management and the Investment Consultant were obligated to perform adequate due diligence, investigation and analysis prior to respectively causing and recommending that Andover continually invest with Madoff and his firm.

85. Additionally, Andover Management and the Investment Consultant were obligated to properly monitor Andover's policy of committing and then maintaining approximately a quarter of its assets with Madoff and his firm. Andover Management, together with the Investment Consultant are "responsible for...monitoring the Managers' adherence to their stated investment strategies" through evaluating both "quantitative and qualitative" criteria "including analyses of: type of trading program; risk control; duration and speed of recovery from drawdowns; experience; organizational infrastructure; and degree of correlation with traditional investments such as stocks and bonds." See Old Offering Memorandum at 12; New Offering Memorandum at 11.

Failure to Perform Adequate Due Diligence

86. Had Andover Management and the Investment Consultant conducted the proper due diligence, they would have learned of a number of "red flags" – warning signs, irregularities, inconsistencies and unanswered questions – regarding Madoff and his firm, which, in the aggregate, should have caused a person exercising even a minimal level of care to not invest or maintain the investment with him.

87. However, Andover Management and the Investment Consultant gave Madoff and his firm complete discretion to manage approximately a quarter of Andover's assets, despite the alarming number of "red flags" indicating that Madoff did not adhere to his stated investment strategy. Andover Management and the Investment Consultant ignored these "red flags" in violation of their respective duties to Andover:

a) Madoff and his firm purported to follow a "split-strike conversion" strategy in his investments. This strategy is briefly summarized on page 14 of the Old Offering Memorandum and page 13 of the New Offering Memorandum. The stocks involved in this strategy were supposed to highly correlate to the S&P 100 index. However, the Madoff firm's returns could not be independently duplicated by any disinterested quantitative analyst, and a quantitative analysis of the Madoff firm's returns would have indicated that its returns were in fact impossible to achieve.

b) Although Madoff and his firm purported to invest in a basket of securities highly correlated to the S&P 100 index, his purported returns had a suspiciously low 6% correlation to the performance of that index. *See* Testimony of Harry Markopolos

before US House of Representatives Committee on Financial Services, February 4, 2009 (the "Markopolos Testimony").

c) Moreover, according to the Markopolos Testimony, there were not enough S&P 100 index options in existence for the Manager to have used a split-strike conversion strategy for the amount of money it purported to manage.

d) Madoff and his firm reported having preternaturally low volatility and achieving consistent, stable returns in every market environment. According to the Markopolos Testimony, the largest price decline reported by Madoff and his firm during any one month was a suspiciously low -0.55% (one-half of one percent).

e) Madoff and his firm purported to liquidate its positions at each year-end into US Treasury Bills. There is no apparent reason why this should have been done at the end of every year.

f) Unlike most firms handling managed accounts, Madoff's firm did not prepare year-end statements for its clients.

g) The Madoff firm purported to initiate, execute, clear and administer its own trades without an external custodian.

h) Key and control positions at the Madoff firm were held by Madoff's immediate family members

i) The Madoff firm did not have an in-house comptroller, relying instead on an outside comptroller based in Bermuda.

j) The auditor of the Madoff firm consisted of a single CPA working from a 13' x 18' office in Rockland County who, despite being the auditor of a multi-billion dollar

enterprise, was not peer-reviewed or registered with the Public Company Accounting Oversight Board. On March 18, 2009, Madoff's auditor was named as a defendant in civil and criminal proceedings related to the Madoff fraud.

k) The Madoff firm did not permit Andover Management or Andover QP to have electronic access to Andover's account(s). Not providing clients with real-time access to their account information gave Madoff and his firm the time they needed to devise and manufacture fraudulent confirmation tickets and monthly account statements. Not providing electronic access prevented its clients from properly verifying that the Madoff firm was getting the best execution and/or that the purported trades were in fact actually executed.

l) As discussed in paragraphs 76 through 83 above, reports had appeared questioning Madoff's legitimacy. Indeed, a number of respected firms had warned their clients to steer clear of Madoff and his firm.

Failure to Properly Monitor

88. In addition to missing, ignoring, disregarding or failing to understand these "red flags," Andover Management and the Investment Consultant did not properly monitor the Manager's management of Andover's money.

89. Andover had a managed account with Madoff and his firm. The Madoff firm sent Andover paper confirmation tickets reflecting each trade he purportedly made on behalf of Andover, disclosing the price at which each purchase or sale was supposedly made.

90. Every month, Andover also received paper account statements from the Madoff firm. These monthly statements also indicated the prices at which the Madoff firm

purportedly purchased and sold the securities comprising Andover's assets under management.

91. Andover Management should have promptly provided the Investment Consultant with the confirmation tickets and monthly statements, and the Investment Consultant should have asked Andover Management for the confirmation tickets and monthly statements if they were not provided.

92. The Investment Consultant could not discharge its duty of care without having reviewed the confirmation tickets and monthly statements.

93. Andover Management and the Investment Consultant knew or were grossly negligent in not knowing the NASD's (subsequently, FINRA's) best execution rule, as well as the Madoff firm's common law and fiduciary duties to buy and sell securities for Andover at the best possible price. *See* NASD Notice to Members 01-22, FINRA Rule 2320 ("Best Execution and Interpositioning").

94. Had Andover Management and/or the Investment Consultant bothered to compare the purchase and sale prices on the confirmation tickets and monthly statements to each stock's trading range for that they, they each would have learned that a significant portion of the trades purportedly executed by the Madoff firm lay outside the daily trading range of the securities Madoff purported to purchase for Andover.

95. Even standing alone, these out-of-range executions should have indicated to both Andover Management and the Investment Consultant that the Madoff firm was fabricating from whole cloth the contents of the confirmation tickets and monthly account statements. Together with the other "red flags" described above, they should have put

Andover Management and the Investment Consultant on notice that there were serious questions regarding the lack of any substantiation for any of the profits purportedly generated by Madoff and his firm.

96. Even if all of the purported trades were executed within the daily trading range of the relevant securities, Andover Management and/or the Investment Consultant would be unable to verify that the Madoff firm had complied with its best execution obligations in the absence of data indicating the times of day that the relevant orders were placed and executed. Neither Andover Management nor the Investment Consultant ever requested the appropriate trading documentation from the Madoff firm. The failure of the Madoff firm to furnish such documentation would have indicated that the confirmation tickets and monthly statements were fabricated for Andover's managed account.

97. Andover Management and/or the Investment Consultant breached their duties to Andover in failing to so examine the Madoff firm's confirmation tickets and monthly statements, failing to observe that Madoff and his firm regularly and repeatedly breached its best execution obligations, or apparently failing to take any action upon learning of the same.

98. The foregoing is a breach of fiduciary duty.

The Auditors Breached their Duties to Andover

99. Each of the Auditors breached their duties to Andover in connection with the their annual audits of Andover LP by failing to comply with GAAS by reason of, *inter alia*, the following:

- a) failing to properly assess the controls over the custody of portfolio securities and to determine that there were inadequate controls over the custody of securities purportedly held by Madoff and his firm;
- b) failing to confirm the existence, custody and value of portfolio securities purportedly held by Madoff and his firm both at year end and at any interim dates;
- c) failing to test a sample of portfolio transactions purportedly executed by the Madoff firm for proper authorization, extensions, trade dates and reasonableness of transaction pricing;
- d) failing to properly test and evaluate the reported income, gains and losses from securities transactions;
- e) failing to assess whether the investments purportedly made by Madoff and his firm were consistent with their purported investment strategies; and
- f) failing to appropriately assess the multiple "red flags" relating to the Madoff investments discussed in paragraph 87 above and how those factors may have an impact on internal controls, the presentation of financial position and results, and additional audit testing to mitigate the risks highlighted by these "red flags."

100. Had each of the Auditors properly planned and performed their annual audits in accordance with GAAS and with proper consideration of the risks caused by Andover's investment of approximately 24% of its assets (in excess of \$12 million) in a discretionary account managed by an outside Manager with multiple "red flag" warning signs, it would, in the absence of negligence, have undertaken additional tests relating to the Madoff firm's

management and purported custody of Andover's assets including but not limited to: (1) audit tests that did not rely exclusively upon the paper confirmation tickets and account statements sent by the Madoff firm to Andover Management; (2) an assessment of Madoff and his firm's purported strategy of converting Andover's investments to US Treasury Bills at year-end, including obtaining a credible explanation of this highly unusual practice; (3) additional confirmation that the Madoff firm actually purchased and held US Treasury Bills for Andover's benefit at the end of each audit year; (4) conducting appropriate testing procedures of the Madoff firm's operations and internal control and custody procedures; and (5) assessing and obtaining a credible explanation of why the trading results of Madoff and his firm were significantly different from those which would be expected under the trading strategy they purported to follow.

101. Had each of the Auditors complied with their professional duty by conducting GAAS-compliant audits of Andover, that Auditor would have determined, *inter alia*, that:

- a) there were inadequate controls over the custody of portfolio securities purportedly held by the Madoff firm;
- b) that the portfolio securities purportedly held by the Madoff firm were in fact non-existent and valueless;
- c) the transactions purportedly executed by the Madoff firm were fictitious in that a substantial portion of the transactions were listed at prices at which were objectively unreasonable as they were outside the securities' trading range for the date of the purported transactions and there was no proper documentary substantiation for the execution of Andover's securities transactions purportedly made by the Madoff firm;

d) the income, gains and losses from securities transactions were false in that they were based on objectively unreasonable trade prices;

e) the investments purportedly made by Madoff and his firm were inconsistent with their purported investment strategy in that the returns claimed to have been received were wildly divergent from those to be expected from the strategy and that Madoff and his firm always converted the investments to cash or cash equivalents at each year end; and

f) the multiple "red flags" relating to the investments made by Madoff and his firm discussed in paragraph 87 above, were indicators that the investment of approximately a quarter of Andover's assets with the Manager constituted a substantial audit risk, and that had appropriate audit procedures to address that risk been undertaken, each of the Auditors would have determined that the transactions purportedly undertaken by the Manager and the securities purportedly held by the Madoff firm were wholly fictitious.

102. Had the Auditors complied with their professional duty and conducted the audits of Andover LP in compliance with GAAS, it would have not issued an unqualified audit opinions as to the financial position of Andover LP.

103. Had each of the Auditors not issued such unqualified audit opinions, Andover Management would not have caused Andover to maintain its investment of approximately a quarter of its assets with the Manager.

AS AND FOR A FIRST CAUSE OF ACTION
(Breach of Fiduciary Duty: Andover Management)

104. Plaintiffs repeat and reallege paragraphs 1 through 103 as if they were fully set forth herein.

105. Andover Management owed a fiduciary duty to Andover LLC and Andover LP.

106. Andover Management breached its fiduciary duties to Andover LLC and Andover LP by failing to conduct proper due diligence and failing to exercise reasonable care in giving Madoff and his firm free reign to manage approximately 24% of Andover's assets in spite of the myriad "red flags" and reports in the industry and media which should have raised significant and troubling questions.

107. Andover Management breached its fiduciary duty to Andover LLC and Andover LP by improperly monitoring Andover's investment with Madoff and his firm, including the failure to adequately review the confirmation tickets and monthly account statements.

108. Andover Management failed to safely manage Andover's capital, did not investigate the "red flags" even as they were reported in the press, and together with the Auditors, did not provide Andover with accurate financial statements.

109. Approximately 24% of Andover's assets have been rendered worthless as the proximate result of Andover Management breaching its fiduciary duty, thereby damaging Andover LLC in an amount in excess of \$75,000 to be determined at trial.

AS AND FOR A SECOND CAUSE OF ACTION

(Aiding and Abetting Breach of Fiduciary Duty: Danziger and Markhoff)

110. Plaintiffs repeat and reallege paragraphs 1 through 109 as if they were fully set forth herein.

111. Andover Management owed a fiduciary duty to Andover LLC and Andover LP.

112. As the control persons of Andover Management, and as attorneys, Danziger and Markhoff knew known that Andover Management owed a fiduciary duty to Andover LLC and Andover LP.

113. As the control persons of Andover Management, and as attorneys, Danziger and Markhoff knew that Andover Management had breached its fiduciary duty to Andover LLC and Andover LP by virtue of the reasons set forth in paragraphs 1 through 109.

114. Danziger and Markhoff substantially assisted Andover Management's breach of fiduciary duty by creating, personally overseeing and supervising the processes, and setting the standards (or lack thereof), under which Andover Management selected Madoff and his firm as the Manager of approximately 24% of Andover's assets and under which Andover Management purported to continually monitor the Manager's performance. Danziger and Markhoff's personally lax or nonexistent monitoring caused Andover Management to breach its fiduciary duties to Andover LLC and Andover LP.

115. Danziger and Markhoff affirmatively caused Andover Management to abdicate its duty to oversee the Manager and ensure that Andover's assets were properly invested and that the Manager was adhering to its stated investment strategy.

116. As set forth in paragraphs 1 through 109, Andover was damaged as the result of Andover Management's breach of fiduciary duty.

117. Andover has been damaged in an amount to be determined at trial in excess of \$75,000 as a proximate result of Danziger and Markhoff's aiding and abetting Andover Management's breach of its fiduciary duty.

AS AND FOR A THIRD CAUSE OF ACTION

(Gross Negligence: Andover Management)

118. Plaintiffs repeat and reallege paragraphs 1 through 117 as if they were fully set forth herein.

119. Andover Management owed Andover LLC and Andover LP a duty to use reasonable care in selecting Andover's investment managers.

120. Andover Management was grossly negligent in failing to conduct proper due diligence before committing and continuing to maintain approximately a quarter of Andover's assets with Madoff and his firm in light of the myriad "red flags" and reports surrounding the Manager.

121. Andover Management was grossly negligent by improperly monitoring Andover's investment with the Manager, including the failure to adequately review Andover's confirmation tickets and monthly account statements.

122. Andover has been damaged in an amount to be determined at trial in excess of \$75,000 as a proximate result of the actions of Andover Management.

AS AND FOR A FOURTH CAUSE OF ACTION

(Negligence: Investment Consultant)

123. Plaintiffs repeat and reallege paragraphs 1 through 122 as if they were fully set forth herein.

124. The Investment Consultant owed a duty of reasonable care to Andover Management and through Andover Management to Andover LLC and Andover LP.

125. The Investment Consultant breached its duty of care because it was negligent in recommending that Andover initially invest approximately a quarter of its assets and then maintain that level of investment with the Manager without conducting the proper due diligence and in light of the myriad "red flags" and reports surrounding the Manager and its principals.

126. The Investment Consultant was negligent in monitoring the investment of almost a quarter of Andover's assets with the Manager, including the failure to adequately review Andover's confirmation tickets and monthly account statements.

127. Andover has been damaged in an amount to be determined at trial in excess of \$75,000 as a proximate result of the actions of the Investment Consultant.

AS AND FOR A FIFTH CAUSE OF ACTION
(Breach of Contract: Investment Consultant)

128. Plaintiffs repeat and reallege paragraphs 1 through 127 as if they were fully set forth herein.

129. The Investment Consultant provided its services pursuant to separate contracts with Andover Management and Andover LLC.

130. Andover was an intended third-party beneficiary of the Investment Consultant's contract with Andover Management.

131. The Investment Consultant breached its contractual obligations by recommending that Andover initially invest approximately a quarter of its assets, and then

maintain that level of investment with the Manager without conducting the proper due diligence, especially in light of the myriad "red flags" surrounding that company and numerous industry and media reports.

132. The Investment Consultant breached its contractual obligations by improperly monitoring Andover's investment with the Manager, including the failure to adequately review Andover's confirmation tickets and monthly account statements issued by the Madoff firm.

133. Andover was damaged in an amount to be determined at trial in excess of \$75,000 as a proximate result of the Investment Consultant's breach of its contracts with Andover Management and/or Andover LLC.

AS AND FOR A SIXTH CAUSE OF ACTION

(Unjust Enrichment: Andover Management)

134. Plaintiffs repeat and reallege paragraphs 1 through 133 as if they were fully set forth herein.

135. Andover Management's conduct has resulted in approximately 24% of Andover's assets being rendered worthless.

136. Andover Management charged and collected from the limited partners and non-managing members of, respectively, Andover LP and Andover LLC, monthly management fees and a percentage annual profit allocation amounting in the aggregate to millions of dollars, despite Andover Management's breach of fiduciary duty and/or gross negligence in causing Andover to initially invest approximately a quarter of its assets and then maintain this level of investment with the Manager without having performed adequate

due diligence and in spite of the myriad "red flags" and reports in the industry and media surrounding Madoff and his firm.

137. Andover Management abdicated its duty to monitor the Manager's performance and adherence to its stated investment objectives after having made the decision to continually entrust approximately a quarter Andover's assets to it.

138. As approximately 24% of Andover's investment was fictitious, Andover Management is not entitled to receive any funds from Andover or its limited partners or non-managing members, as the case may be, representing any allocation of profits from this fictitious investment. Nevertheless, Andover Management received and kept the entirety of its annual profit allocations notwithstanding that a significant portion of those profits was nonexistent in that they were attributable to a wholly fictitious investment.

139. Andover Management has been unjustly enriched.

140. Equity requires that Andover Management disgorge its unjust enrichment to Andover in an amount in excess of \$75,000 to be determined at trial.

AS AND FOR A SEVENTH CAUSE OF ACTION

(Negligence: Auditors)

141. Plaintiffs repeat and reallege paragraphs 1 through 140 as if they were fully set forth herein

142. Each of the Auditors had a professional duty to Andover to conduct their audits of Andover LP with due professional care and in accordance with GAAS.

143. Each of the breached their duty by failing to conduct its audits with due professional care and in accordance with GAAS.

144. Each of the breach of duty damaged Andover an amount in excess of \$75,000 to be determined at trial.

WHEREFORE, plaintiffs demand judgment on behalf of Andover LLC as follows:

1. Determining that this is a proper derivative action, that Plaintiff is a fair and adequate representative of Andover, and that demand on Andover Management to bring this action is excused as it would be futile;
2. Awarding Andover such monetary damages as are determined at trial in an amount in excess of \$75,000;
3. Awarding Plaintiff the costs and disbursements of this action, including reasonable attorneys' fees, and
4. Granting such other and further relief as the Court deems just and proper.

Dated: New York, New York
March 31, 2009

HECHT & ASSOCIATES, P.C.

By: 

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