New Issues in Fraud:

Causes of Action and Defenses

By:
Kathy Bazoian Phelps[1]
Danning, Gill, Diamond & Kollitz, LLP
1900 Avenue of the Stars, 11th Floor
Los Angeles, CA 90067

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When a fraudulent scheme is exposed and the tangible assets and cash of the wrongdoer are long gone, injured plaintiffs must turn to litigation in their efforts to make themselves whole. Transferees of property of the perpetrator are easy targets, as are the professionals who assisted the wrongdoer, sometimes unwittingly, along with the officers and directors of the wrongdoing company. Trustees, receivers and creditors compete for standing to pursue claims against these transferees, professionals and insiders. The defendants aggressively pursue all available defenses, often obtaining dismissal of the claims against them at the pleading stage on motions to dismiss.

Part I of this paper will identify the basic elements of the more common claims for relief which may be used to pursue damage claims against transferees, professionals and insiders associated with the wrongdoer, such as lawyers, accountants, brokers, banks, lenders, and officers and directors. Due to space limitations, this paper is not intended to be a comprehensive review of all types of possible claims which may be brought against third parties. New decisions from the *Bernard L. Madoff Investment Securities, LLC* case are included to demonstrate how these common claims have played out recently in a high profile Ponzi case. Part II will review the three most common defenses brought by defendants to claims brought against them due to their involvement with a wrongdoer – good faith, lack of standing and *in pari delicto*.

PART I

Claims for Recovery Against Transferees, Professionals and Insiders

Much to the dismay of transferees, professionals and insiders, there are numerous different types of tort, statutory and equitable theories available under federal and state laws to pursue damage claims against them. In addition to fraudulent transfer claims to recover funds

actually paid to them, there are a few dozen other types of claims for relief that can be pursued. A few of the more common theories are discussed below.

A. Fraudulent Transfer Claims

A trustee may "claw back" the transfers that a debtor made to investors, sales people, friends, family, or others, under the fraudulent transfer laws available under § 548 of the Bankruptcy Code or applicable state law. Claw back claims can be based on either of two theories – actual intent to hinder delay or defraud creditors, or constructive fraud.

In a fraudulent scheme that has been established as a Ponzi scheme, a unique presumption can be established in connection with actual fraudulent transfer claims that transfers made by a Ponzi debtor were made with the actual intent to hinder, delay or defraud creditors, thus establishing the prima facie claim for relief.[2] The bankruptcy court in the *Madoff* case has recently reaffirmed that the Ponzi presumption is alive and well, noting that it applies in connection with the recovery of commissions as well as to other types of fraudulent transfers.[3]

Courts have found that, among other things, in order to establish a Ponzi scheme, a plaintiff must establish: "(1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors."[4]

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[2] *See, e.g., Donell v Kowell,* 533 F.3d 762, 770 (9th Cir. 2008); *see also Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008)("[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to hinder, delay or defraud").

[3] *Picard v. Cohmad Securities Corp.* (*In re Bernard L. Madoff Inv. Sec. LLC*), 454 B.R. 317, 330 (Bankr. S.D.N.Y 2011).

[4] *Rieser v. Hayslip, et al.* (*In re Canyon Sys. Corp.),* 343 B.R. 615, 630 (Bankr.S.D.Ohio 2006).

If a Ponzi scheme cannot be conclusively established, then a plaintiff may try to establish actual fraudulent intent through a more customary "badges of fraud" analysis using circumstantial evidence.[5] Alternatively, a plaintiff can establish fraudulent intent by relying on an admission of the debtor, usually in a criminal plea agreement, or if the debtor is found criminally liable for fraud.[6]

Under a constructive fraudulent transfer theory, a trustee must establish that the debtor did not receive reasonably equivalent value in exchange for the transfers and that the debtor was then insolvent or became insolvent as a result of the transfer.[7] In cases involving defrauded investors who received payments from the debtor, courts have distinguished between a return of the principal invested and payment of profits in evaluating whether reasonably equivalent value was given in exchange for the transfers. Regarding recovery of principal payments, the Ninth Circuit has held that only profits are recoverable on the basis of a lack of reasonably equivalent value, unless it can be proven that the investor lacked good faith when it received back principal amounts as well.[8] Most courts find that a transfer to an investor as a return of principal is not recoverable because the transfer partially or fully extinguishes the investor's restitution claim

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[5] The Uniform Fraudulent Transfer Act § 4(a)(1) provides a non-exclusive list of badges of fraud. UFTA § 4(a)(1) lists "badges of fraud" as evidence relevant to the debtor's intent. *See also In re Lull*, 386 B.R. 261, 270 (Bankr.D. Haw. 2008) (actual intent may be established where transfer wears a sufficient number of badges of fraud).

[6] *See, e.g., Santa Barbara Capital Management v. Neilson (In re Slatkin),* 525 F.3d 805, 814 (9th Cir. 2008)**("**a debtor's admission, through guilty pleas and a plea agreement admissible under the Federal Rules of Evidence, that he operated a Ponzi scheme with the actual intent to defraud his creditors conclusively establishes the debtor's fraudulent intent under 11 U.S.C. § 548(a)(1)(A) and California Civil Code § 3439.04(a)(1), and precludes relitigation of that issue").

[7] 11 U.S.C. § 548(a)(2); *see also* Cal.Civ.Code § 3439.04(a)(2).

[8] *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008); *Fisher v. Sellis* (*In re Lake States Commodities, Inc.*), 253 B.R. 866, 872 (Bankr. N.D. Ill. 2000) ("[A]n investor having actual knowledge of the underlying fraud may not have a claim for restitution, and will not be deemed to have given reasonably equivalent value in exchange for payments from a Ponzi scheme.").

against the debtor (assuming the subjective good faith of the investor).[9] In the *Madoff* case, the court also concluded that transferees were not entitled to assert restitution claims, observing that "Only innocent investors who reasonably believed that they were investing in a legitimate enterprise are entitled to claims for restitution."[10]

Regarding recovery of profits paid to an investor, while most courts find that no reasonable equivalent value is provided in exchange for those transfers,[11] others have placed their focus on the contractual relationship between the investor and the debtor.[12] Those courts find that the court must measure what was given against what was received in that particular transaction, and conclude in some instances that the debtor's use of the investor's funds for a period of time supported the payment of reasonable contractual interest.

Similarly, a split of authority exists regarding commission payments made to brokers. Some courts have found that because a fraudulent enterprise has no legitimate purpose, there can be no value provided by a broker in furthering or assisting the debtor in perpetrating the fraud, so the commissions paid to the broker are recoverable.[13] Other courts have looked more narrowly

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[9] *Barclay v. Mackenzie* (*In re AFI Holding, Inc.*), 525 F.3d 700, 704 (9th Cir. 2008).

[10] *Picard v. Estate of Chais* (*In re Bernard L. Madoff Inv. Sec. LLC*), 445 B.R. 206, 225 (Bankr. S.D.N.Y. 2010).

[11] *Merrill v. Abbott* (*In re Independent Clearing House Co.*), 77 B.R. 843, 858 (D. Utah 1987) ("To allow an [investor] to enforce his contract to recover promised returns in excess of his [investment] would be to further the debtor's fraudulent scheme at the expense of other [investors]"); *see also Scholes v. Lehmann*, 56 F.3d at 757 ("A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits . . . conferred no benefit on the [debtors] but merely depleted their resources faster.").

[12] *See Lustig v. Weisz & Assoc., Inc.* (*In re Unified Commercial Capital, Inc.*), 260 B.R. 343, 350 (Bankr.W.D.N.Y. 2001)(finding that debtor's use of investor's funds for a period of time supported the payment of reasonable contractual interest; courts cannot ignore what is clearly value and fair consideration under the fraudulent conveyance statutes).

[13] *See, e.g., Warfield v. Byron*, 436 F.3d 551, 560 (5th Cir. 2006) ("It takes cheek to contend that in exchange for the payments he received, the [debtor's] Ponzi scheme benefited from his efforts to extend the fraud by securing new investments.").

at the relationship between the debtor and the broker and measure "what was given and received" by the debtor and the broker, comparing market commission rates with what was paid.[14] This line of cases finds that value can be found in certain circumstances, and the court must evaluate the consideration exchanged by the debtor and transferee in the specific transaction which is sought to be avoided, not the transaction's impact on the debtor's overall business.[15] A recent *Madoff* decision relating to brokers' commissions, while open to considering the specific transaction and commission rates, limited that consideration to those circumstances in which the brokers were innocent.[16]

B. Malpractice and Professional Negligence

Perpetrators of fraudulent schemes often solicit the assistance of attorneys, accountants, auditors, sales people, and other professionals to give their fraudulent business an air of legitimacy. For example, the perpetrator asks the professional to issue private placement memoranda or audited financial statements so that the company can then distribute that documentation to its investors to solicit more investments. Those professionals often later find themselves the targets of malpractice lawsuits for the services they provided before the fraudulent scheme collapsed.

Malpractice, whether by an accountant or an attorney, is founded in state law and is based on a negligence theory of liability.[17] Under California law, the plaintiff must prove the following

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[14] *In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000).

[15] *Id.* ("Money is valuable even when used for illegal purposes.").

[16] *Picard v. Cohmad Sec. Corp.* (*In re Bernard L. Madoff Inv. Sec. LLC*), 454 B.R. 317, 334-35 (S.D.N.Y. 2011) (denying defendants' motion to dismiss based on allegations of a lack of innocence on the part of the brokers).

[17] *Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*), 448 F.3d 672, 677 (3d Cir. 2006).

elements to establish a claim for professional negligence: "that the defendant failed to use the skill and care that a reasonably careful professional operating in the field would have used in similar circumstances, and that the defendant's failure proximately causes damage to plaintiff."[18] Generally, an attorney or an accountant for a client perpetrating a fraudulent scheme owes duties only to the client and does not owe any duty to the investors of its client.[19] However, an investor may bring a claim against the perpetrator's professional in instances of fraud, or for conduct equivalent to fraud, such as gross negligence.[20]

In *Lautenberg Foundation v. Madoff*, the court declined to dismiss a negligence claim based on the court's holding that the complaint adequately alleged a fiduciary duty and breach of that fiduciary duty.[21] In that case, the plaintiff alleged a fiduciary duty to safeguard money entrusted to the debtor against fraud, misappropriation or other wrongdoing by the debtor and that this duty was breached by the defendant, causing the plaintiff's loss.

C. Negligent Misrepresentation

A claim for negligent misrepresentation may similarly be brought against professionals who misrepresented information upon which others relied upon in doing business with the wrongdoing defendant.

> The elements of a negligent misrepresentation claim are (1) the misrepresentation of a past or existing material fact, (2) without

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[18] *Mosier v. Stonefield Josephson, Inc.,* 2011 U.S. Dist. LEXIS 124058, at *18 (C.D. Cal. Oct. 25, 2011) (citations omitted).

[19] *International Strategies Group, Ltd. v. Greenberg Traurig, LLP*, 482 F.3d 1 (1st Cir. 2007).

[20] *Silverman v. KPMG LLP* (*In re Allou Distributors, Inc.*), 395 B.R. 246, 259-60 (Bankr. E.D.N.Y. 2008) (citation omitted) ("A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet.").

[21] *Lautenberg Found. v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *20-25 (D.N.J. Sept. 9, 2009).

> reasonable ground for believing it to be true, (3) with intent to induce another's reliance on the fact misrepresented, (4) justifiable reliance on the misrepresentation, and (5) resulting damage.[22]

As is the case with a malpractice claim, a claim for negligent misrepresentation may be brought by an investor only in limited circumstances. "The general rule is that a professional owes a duty to a third party only if that third party is within the "limited group of persons for whose benefit and guidance [the defendant] intends to supply the information or knows that the recipient intends to supply it."[23] Other courts have found that, "To state a claim for negligent misrepresentation against a professional defendant, the plaintiff must be in privity with the defendant or in a 'relationship "so close to approach that of privity."'"[24]

D. Deepening Insolvency

Trustees, receivers, and even investors under some circumstances, can assert claims for damages to the corporate entity based on a "deepening insolvency" theory, either as a direct claim for relief or as a theory of damages. Deepening insolvency has been defined as "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[25] In *Lafferty*, the creditors' committee brought an action against the debtor's officers, directors and outside professionals, alleging that through mismanagement

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[22] *Mosier v. Stonefield Josephson, Inc.,* 2011 U.S. Dist. LEXIS 124058, at *20 (C.D. Cal. Oct. 25, 2011).

[23] *Facciola v. Greenberg Traurig LLP*, 2011 U.S. Dist. LEXIS 61785, at *35 (D. Ariz. June 9, 2011); 2011); *see also Duke v. Touche Ross & Co*., 765 F. Supp. 69, 77 (S.D.N.Y. 1991) (investors stated negligent misrepresentation claim against accounting firm that prepared private placement memorandums because documentation was distributed to select group of qualified investors, rather than the public at large, and firm allegedly solicited some investors).

[24] *In re Colonial Ltd. Partnership Litigation,* 854 F. Supp. 64, 102 (D. Conn. 1994) (quotations omitted) (denying defendant's motion to dismiss and noting that, "plaintiffs allege that Arthur Andersen knew members of the class would rely on the representations contained in the PPMs in deciding whether to invest in the limited partnerships.").

[25] *Official Comm. Of Unsecured Creditors v. R.F. Laffferty & Co*., 267 F.3d 340, 347 (3d Cir. 2001).

and participation in a fraudulent Ponzi scheme, the defendants wrongfully prolonged the debtor's life and incurred debt beyond the debtor's ability to pay, ultimately forcing the debtor into bankruptcy.

Some courts have found that state law in their jurisdiction permits an independent claim for relief based on deepening insolvency, which generally require the following elements to establish the claim: (1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation.[26] Other courts have found that negligence is sufficient to sustain a claim for deepening insolvency.[27] Some courts reject deepening insolvency as an independent cause of action,[28] and other courts recognize deepening insolvency as a theory of damages only.[29] Plaintiffs can allege that the tortuous conduct of the defendant caused the debtor to take on new liabilities which rendered the debtor unable to pay its creditors and the debtor's insolvent position increased over time.[30]

Neither California nor the Ninth Circuit have expressly adopted or rejected deepening insolvency as either an independent tort or as a theory of damages, but the Ninth Circuit has

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[26] *Official Comm. Of Unsecured Creditors v. Foss* (*In re Felt Mfg. Co., Inc.),* 371 B.R. 589 (Bankr. D.N.H. 2007).

[27] *See, e.g., In re LTV Steel Co., Inc.*, 333 B.R. 397 (Bankr. N.D. Ohio 2005) (either fraudulent or negligent conduct that prolongs the life of corporation, thereby increasing the corporation's debt and exposure to creditors, may give rise to deepening insolvency claim).

[28] *See, e.g., Wooley v. Faulkner* (*In re SI Restructuring, Inc.*), 532 F.3d 355, 363 (5th Cir. 2008); s*ee also Torch Liquidating Trust v. Stockstill*, 561 F.3d 377 (5th Cir. 2009) (holding that Delaware does not recognize cause of action on behalf of corporation for deepening insolvency); *Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7th Cir. 2007) (rejecting a deepening insolvency claim against debtor's auditors because it was not based on an existing legal duty); *Trenwick Am. Litigation Trust v. Ernst & Young*, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

[29] *Thabault v. Chait*, 541 F.3d 512, 522 (3d Cir. 2008); *see also Silverman v. KPMG, LLP* (*In re Allou Distribs., Inc.*), 395 B.R. 246, 264-65 (E.D.N.Y. 2008); *NCP Litig. Trust v. KPMG*, 945 A.2d 132 (N.J. Super. 2007).

[30] *See, e.g., Silverman v. KPMG LLP* (*In re Allou Distributors, Inc.*), 395 B.R. 246, 267 (Bankr. E.D.N.Y. 2008).

recognized its utility as a tool for a trustee or receiver to obtain standing by alleging harm to the debtor entity.[31]

F. Fraud

In some circumstances, professionals may have knowingly and actively agreed to participate in the fraudulent activity themselves. In addition to claims for conspiracy, or aiding and abetting liability, discussed below, those defendants may find they have potential liability for fraud. To establish a claim of fraud (sometimes called "fraudulent misrepresentation"), under California law, the plaintiff must establish: "(a) misrepresentation (false representation, concealment, or nondisclosure); (b) knowledge of falsity (or 'scienter'); (c) intent to defraud, i.e., to induce reliance; (d) justifiable reliance; and (e) resulting damage."[32]

Knowledge of the fraud on the part of the professional is a key element in imposing liability on that professional. In connection with the *Madoff* Ponzi scheme, the court dismissed a fraud claim against the auditor because the complaint did "not allege facts from which the court could infer that the auditor actually knew about and ignored most of these warning signs."[33] The court noted:

> But an unseen red flag cannot be heeded. Hence courts in this Circuit have consistently dismissed fraud claims against auditors-including against auditors of BMIS feeder funds-that have not sufficiently alleged that an auditor knew of red flags. *See In re Beacon Assoc. Litig.*, No. 09-CV-777, 2010 WL 3895582, at *22 (S.D.N.Y. Oct. 5, 2010) ("Plaintiffs allege a litany of red flags, but fail to allege sufficiently that Friedburg ever became aware of

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[31] *Smith v. Arthur Anderson LLP*, 421 F.3d 989, 1004-06 (9th Cir. 2005) ("This allegedly wrongful expenditure of corporate assets qualifies as an injury to the firm which is sufficient to confer standing upon the Trustee.").

[32] *Lazar v. Superior Court*, 12 Cal. 4th 631, 638, 49 Cal. Rptr. 2d 377, 909 P.2d 981 (1996).

[33] *Stephenson v. PricewaterhouseCoopers LLP*, 768 F. Supp. 2d 562, 571 (S.D.N.Y. 2011).

> them. . . . Such allegations do not support a strong inference that Friedburg was aware of red flags and acted with scienter.").

F. Aiding and Abetting Fraud and Breach of Fiduciary Obligations

Aiding and abetting theories of recovery may also be brought against third parties who have been involved in a fraudulent scheme. Under California law, aiding and abetting liability may be established as follows:

> Liability may . . . be imposed on one who aids and abets the commission of an intentional tort if the person (a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortious result and the person's own conduct, separately considered, constitutes a breach of duty to the third person.[34]

In establishing the defendant's knowledge of the fraud or of the breach of fiduciary obligation, actual knowledge must be proven; constructive knowledge is insufficient.[35] In the Ponzi case of Reed Slatkin, the court noted, "while aiding and abetting may not require a defendant to agree to join the wrongful conduct, it necessarily requires a defendant to reach a conscious decision to participate in tortious activity for the purpose of assisting another in performing a wrongful act."[36]

In additional to actual knowledge, there must also be substantial assistance in the fraud, or inducement or participation in the breach of fiduciary duty.[37] "Substantial assistance" and

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[34] *Casey v. U.S. Bank Nat'l Assoc.,* 127 Cal. App.4th 1138, 1144, 26 Cal. Rptr.3d 401, 405 (2005) (citation omitted).

[35] *Neilson v. Union Bank, N.A.*, 290 F. Supp. 2d 1101, 118-19 (C.D. Cal. 2003) ("federal courts have found that the phrase 'knew or should have known' does not plead actual knowledge.").

[36] *Id.* (citation omitted). The California Supreme Court has explained, "The words 'aid and abet' as thus used have a well understood meaning, and may fairly be construed to imply an intentional participation with knowledge of the object to be attained. *Lomita Land Water Co. v. Robinson*, 154 Cal. 36 (1908).

[37] *See Sharp Int'l Corp. v. State Street Bank & Trust Co.* (*In re Sharp Int'l Corp.*), 403 F.3d 43, 52-53 (2d

"participation" have been found "to exist where a defendant 'affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed.'"[38]

G. Claims Against Officers and Directors: Breach of Fiduciary Duty

Plaintiffs often bring claims against the individuals responsible for the fraud on the basis of a breach of fiduciary duty. The elements of a breach of fiduciary duty claim are: (1) the existence of a fiduciary relationship giving rise to a fiduciary duty, (2) breach of that duty, and (3) damage proximately caused by the breach.[39] Directors and officers owe three different types of fiduciary duties to the corporation and its shareholders – the duties of loyalty, good faith, and due care.[40] Generally speaking, fiduciary duties prohibit self-dealing by corporate officers and directors who use corporate assets for personal gain.[41]

To judge the reasonableness of a director's or officer's actions, courts have created the business judgment rule which is a "presumption that 'in making a business decision the directors [and officers] of a corporation acted on an informed basis, in good faith and in the honest belief

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Cir. 2005) (concluding that it was unnecessary to resolve the issue of the defendant's knowledge because there was insufficient evidence of substantial assistance, and that even if the defendant knew of the fraud, it had no separate duty to disclose it.).

[38] *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001) (citations omitted); *see also Lautenberg Found. v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *50 (D.N.J. Sept. 9, 2009) (rejecting defendant's assertion that complaint asserted only mere inaction and finding allegations sufficient that defendant provided substantial assistance "by failing to maintain and enforce a system of internal controls, as he was required to do in his role as BMIS's compliance officer . . . .). Under California law, courts have found that "'ordinary business transactions' that a bank performs for a customer can satisfy the substantial assistance element of an aiding and abetting claim if the bank actually knew those transactions were assisting the customer in committing the specific tort." *Casey*, 127 Cal. App.4th at 1145; *see also Henry v. Lehman Commercial Paper, Inc.* (*In re First Alliance Mortg. Co.*), 471 F.3d 977, 994-95 (9th Cir. 2006) (noting that, while the definition of "substantial assistance" is not clear under California law, even "ordinary business transactions" can constitute substantial assistance).

[39] *Pierce v. Lyman*, 1 Cal.App.4th 1093, 1101, 3 Cal.Rptr.2d 236 (1991).

[40] *See, e.g.*, *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). The duties are owed by both directors and officers. *Stanziale v. Nachtomi* (*In re Tower Air, Inc.*), 416 F.3d 229, 239-41 (3d Cir. 2005).

[41] *Pepper v. Litton*, 308 U.S. 295, 311 (1939).

that the action taken was in the best interests of the company [and its shareholders].'"[42] The protection of the business judgment rule may be lost, however, if the plaintiff can prove that the officer or director breached his fiduciary duty of loyalty, good faith or care.[43]

As recently noted in the *Madoff* case, breach of fiduciary duty claims may also be brought against a broker, or a corporate broker's controlling shareholder, officer or director under some state laws.[44]

PART II

DEFENSES AVAILABLE TO INSIDERS AND PROFESSIONALS

In response to claims brought against them, the target defendants may have several available defenses. This section discusses three of the most common defenses brought in Ponzi and other fraudulent scheme cases – (1) good faith; (2) lack of standing; and (3) the *in pari delicto* doctrine.

A. Good Faith Value Defense

Under either an actual fraudulent intent theory or a constructive fraud theory of recovery against a transferee, the good faith of the investor-transferee is relevant, assuming value was provided, in establishing a partial or complete defense, depending on the circumstances.[45] The

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[42] *In re Greater Southeast Community. Hosp. Corp. I*, 353 B.R. 324, 343 n.26 (Bankr. D. Colo. 2006) (citations omitted); *see also In re Abbott Labs. Deriv. Shareholders Litig*., 325 F.3d 795, 807 (7th Cir. 2003); *Alliant Energy Corp. v. Bie*, 277 F.3d 916, 918 (7th Cir. 2002) ("[I]f directors act loyally and carefully, they are not liable even if the transaction goes awry."); *FDIC v. Stahl*, 89 F.3d 1510 (11th Cir. 1996); *Everest Investors 8 v. McNeil Partners*, 114 Cal.App.4th 411, 430 (2003).

[43] *Boles v. Filipowski* (*In re Enivid. Inc.*), 345 B.R. 426, 442 (Bankr. D. Mass. 2006).

[44] *Lautenberg Foundation v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *50 (D.N.J. Sept. 9, 2009) ("a fiduciary duty exists between a broker and a client "where the customer has delegated discretionary trading authority to the broker .").

[45] 11 U.S.C. § 548(c). Most state statutes also create an exception for the transferee or obligee who takes

analysis regarding whether value was provided for purposes of a good faith value defense is essentially the same as a reasonably equivalent value analysis in connection with the *prima facie* case.[46]

The focus of a courts' inquiry regarding good faith centers around the state of mind of the transferee -- whether the transferee has knowledge of the debtor's insolvency or fraudulent activity; whether that knowledge is actual or constructive, whether the transferee should have been placed on inquiry notice, and what type of investigation was conducting after the transferee was placed on inquiry notice. Most courts consider whether the transferee objectively knew or should have known of the debtor's fraudulent purpose in making the transfer.[47]

"Certainly, if a defendant knew that the debtor was running a Ponzi scheme when he advanced money to the debtor or knew of the debtor's insolvency at the time of the allegedly fraudulent transfer, that knowledge might indicate a lack of good faith."[48] If the circumstances would place a reasonable person on inquiry of the fraudulent scheme, then good faith will not likely be found.[49] Most courts have found that inquiry notice exists if there were red flags regarding the purpose of the transfer, the underlying fraud of the Ponzi scheme, the unfavorable financial condition of the transferor, the insolvency of the transferor, the improper nature of a

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the property in good faith and for value. *See, e.g.*, Cal.Civ.Code § 3439.08(a). Another defense available in fraudulent transfer cases, not discussed herein, is the stockbroker defense under 11 U.S.C. § 546(e).

[46] *Barclay v. Mackenzie* (*In re AFI Holding, Inc.*), 525 F.3d 700, 707 (9th Cir. 2008) ("We find no reason, in statute or case law, to treat 'reasonably equivalent value' differently for each of the Code provisions [§§ 548(a)(1)(B) and 548(c)].").

[47] *See, e.g., In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 535 (9th Cir. 1990).

[48] *Merrill v. Abbott* (*In re Independent Clearing House Co.*), 77 B.R. 843, 861 (D. Utah 1987).

[49] *Jobin v. McKay* (*M & L Business Machine Co.*), 84 F.3d 1330, 1338 (10th Cir. 1996).

transaction, or the voidability of the transfer.[50] Some of the factors which have been found sufficient to constitute "red flags" putting an investor on inquiry notice are:

- A promise of very high or exorbitant returns should put an investor on inquiry notice.[51]
- If the circumstances would place a reasonable person on inquiry notice and a diligent inquiry would have uncovered the fraud, then a finding of a lack of good faith will likely be made.[52]
- An investor's education and experience can preclude a finding of good faith.[53]
- If insufficient due diligence was done by the investor, then good faith may not be found.[54]

B. Standing

The first question a defendant should ask in response to a complaint is whether the plaintiff is the proper party to be bringing the claim against the defendant. Trustees and receivers often bring claims that courts determine belong to the investors, and vice versa. The line between whether the claim is properly brought by the trustee or receiver as opposed to the

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[50] *Plotkin v. Pomona Valley Imports (In re Cohen)*, 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996)("Such inquiry notice suffices on the rationale that some facts suggest the presence of others to which a transferee may not safely turn a blind eye").

[51] *See*, *e.g.*, *Jobin v. Lalan* (*In re M&L Bus. Mach. Co.*), 160 B.R. 851, 859 (Bankr. D. Colo. 1993), *aff'd* 167 B.R. 219 (D. Colo. 1994)(a Ponzi-scheme investor did not act in good faith in pursuing a supposedly risk-free investment promising profits of 125 percent to 512 percent); *Scholes v. Lehmann*, 56 F.3d at 760 ("Only a very foolish, very naïve, very greedy, or very Machiavellian investor would jump at a chance to obtain a return on his passive investment of 10 to 20 percent a month . . . It should be obvious that such returns are not available to passive investors in any known market, save from the operation of luck.").

[52] *Agric. Research*, 916 F.2d at 539; *McKay*, 84 F.3d at 1338-39 (implausible explanation by company officials as to how they could pay such high rates places investor on inquiry notice).

[53] *See, e.g., McKay*, 84 F.3d at 1333 (No good faith finding where investor attended college for three years, studied business administration and bookkeeping, operated his own construction business, a commercial and industrial real estate business, served as co-trustee for a family trust with assets in excess of $3,000,000, and owned a personal portfolio including a variety of stocks, bonds, mutual funds, raw land and promissory notes).

[54] *Lalan*, 160 B.R. at 859(no good faith where investor "ignored his own initial intuition and plunged headlong into scam because of the huge profits he was promised, and which he received."); *see also Cuthill v. Kime* (*In re Evergreen Sec., Ltd.*), 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003).

individual investor is drawn depending on whether the claim belongs to the corporate debtor entity or to the individual investors of the corporate debtor.[55]

A trustee's standing arises from the right to pursue property of the estate under § 541(a) of the Bankruptcy Code.[56] A trustee has standing to assert claims that could have been asserted by the debtor entity as of the date of the petition.[57] The issue in analyzing a trustee's standing, therefore, becomes one of determining who was harmed and who owns the cause of action against a third party -- the debtor or the creditors.[58] In addition to the use of § 541(a) to bring an action as successor to the debtor's interests, a trustee can acquire standing in a few different ways. Section 544(a) can also be used to permit trustees to have standing as a judicial lien creditor and to void transfers of the debtor's property that could have been avoided by an actual creditor.[59] Additionally, the theory of deepening insolvency has been used by some courts to

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[55] *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 433-34 (1972) (holding that bankruptcy trustee has standing to represent only the interests of the debtor corporation and does not have standing to pursue claims for damages against a third party on behalf of one creditor or a group of creditors).

[56] 11 U.S.C. § 541(a)(1); *United States v. Whiting Pools, Inc*., 462 U.S. 198, 203, 205 n.9 (1983) (cause of action held by a debtor is a "legal or equitable interests of the debtor in property" and, therefore, property of the estate pursuant to § 541(a)(1)).

[57] 11 U.S.C. § 544; *Schertz-Cibolo-Universal City, Indep. School Dis. v. Wright* (*In re Educators Group Health Trust*), 25 F.3d 1281, 1283-84 (5th Cir. 1994); *see also Donell v. Kowell*, 533 F.3d 762, 777 (9th Cir. 2008) (receiver has standing to pursue claims against third parties to the extent that the claim is one belonging to the debtor entity as opposed to the individual investors); *Wuliger v. Mfr's Life Ins. Co*., 567 F.3d 787 (6th Cir. 2009); *Marion v. TDI Inc.*, 591 F.3d 137 (3d Cir. 2010).

[58] *Smith v. Arthur Andersen, LLP*, 421 F.3d 989, 1002 (9th Cir. 2005) ("Although the line between 'claims of the debtor,' which a trustee has statutory authority to assert, and 'claims of creditors,' which *Caplin* bars the trustee from pursuing, is not always clear, the focus of the inquiry is on whether the Trustee is seeking to redress injuries to the debtor itself caused by the defendants' alleged conduct.").

[59] *See, e.g., Sender v. Simon* (*In re Hedged-Investment Assocs.*), 84 F.3d 1299 (10th Cir. 1996); *Sender v. Mann*, 423 F. Supp. 1155, 1173-4 (D. Colo. 2006) ("despite *Caplin,"* trustee has standing under § 544 to bring the derivative claims of the creditors). These cases distinguish *Caplin* on the fact that all creditors could have asserted the claim, whereas in *Caplin*, the debenture holders did not constitute all of the creditors holding claims against the debtor.

find that the harm caused by the third party was injury to the corporate entity rather than to the creditors, thereby creating standing for the trustee.[60]

A trustee may also acquire standing to assert claims on behalf of the estate if he takes an unconditional assignment of claims from creditors.[61] In finding that a trustee was not asserting claims on behalf of the creditors as in the case of *Caplin*, but that the unconditional assignments constituted property of the estate, the Fourth Circuit distinguished the Ninth Circuit decision in *Williams v. California 1st Bank*, which had found that an assignment does not confer standing on a trustee.[62] The *Bogdan* court concluded that "*Williams* actually suggests that the unconditional assignments acquired by Bogdan's trustee sufficiently confer standing."[63] In *Bogdan*, the unconditional assignments did not reserve any part of the potential recovery and the assignees were to recover from the general assets of the estate on a *pro rata* basis with all other creditors, making the trustee the real party in interest.

The distinction between whether the claim belongs to the estate or to the individual creditor plaintiff is particularly difficult to ascertain in a Ponzi scheme case. The Seventh Circuit noted the distinction between the different phases of a Ponzi scheme -- the sales to investors versus the embezzlement by management -- in analyzing standing to pursue claims against third

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[60] *Smith v. Arthur Andersen, LLP*, 421 F.3d at 1003 (9th Cir. 2005) ("This allegedly wrongful expenditure of corporate assets qualifies as an injury to the firm which is sufficient to confer standing upon the Trustee"); *see also Marion v. TDI, Inc.*, 591 F.3d 137, 148 (3d Cir. 2010) ("A receiver no doubt has standing to bring a suit on behalf of the debtor corporation against third parties who allegedly helped that corporation's management harm the corporation").

[61] *See, e.g., Logan v. JKV Real Estate Servs.* (*In re Bogdan*), 414 F.3d 507, 512 (4th Cir. 2005).

[62] *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988).

[63] *Bogdan*, 414 F.3d at 513.

parties, and the court found that the receiver had standing to pursue claims regarding the embezzlement phase of a Ponzi scheme, but not claims relating to the sales process.[64]

In the *Madoff* case, the SIPC trustee was denied standing to bring claims for unjust enrichment, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty against certain financial institutions.[65] One district court rejected the trustee's theories of bailment, subrogation and assignment as "convoluted theories."[66] The *Madoff* trustee has appealed these decisions denying him standing to bring these common law claims.

Several other *Madoff* decisions have expressly decided whether a trustee has standing to bring the claims on the facts of those cases. In one decision, the court found that the trustee had standing to pursue breach of fiduciary duty, negligence, unjust enrichment and accounting claims against Madoff's family members who were insiders of BLMIS.[67] In another decision, the court found that the trustee lacked constitutional standing to assert unjust enrichment claims on behalf of customers and not the estate.[68] In another decision, the court found that the trustee did not

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[64] *Knauer v. Jonathon Roberts Fin. Group, Inc.,* 348 F.3d 230, 233-34 (7th Cir. 2003) (In the sales phase, "the schemer solicits and receives money for investment, guaranteeing high returns while doing little with the money to produce actual profits" while in the embezzlement phase, " schemer realizes most of his gains by appropriating large sums of money from the solicited funds, the pace of withdrawals accelerating as he is ready to disband the Ponzi entity and make off with its assets."); *see also Liberte Capital Group, LLC v. Capwill*, 248 Fed. App'x. 650 (6th Cir. 2007) (noting the distinction between the investors' pre-purchase claims of fraudulent inducement to invest, and the receiver's post-purchase claims of dissipation of the assets, and finding that the receiver did not have standing to sue the debtor's brokers for identifying the investors to invest in the debtor's product).

[65] *Picard v. HSBC Bank, PLC,* 454 B.R. 25 (S.D.N.Y. 2011); *see also Picard v. JP Morgan Chase & Co.,* 2011 U.S. Dist. LEXIS 126553, at *13 (S.D.N.Y. Nov. 1, 2011) "[T]there is no doubt that the common law causes of action in the Amended Complaints, premised on a Ponzi scheme of unprecedented scope and duration orchestrated by BMIS, belong to the creditors, not to BMIS.")

[66] *Picard v. HSBC Bank, PLC,* 454 B.R. 25 (S.D.N.Y. 2011).

[67] *Picard v. Madoff* (*In re Bernard L. Madoff Inv. Sec. LLC*), 2011 Bankr. LEXIS 3578, at *70-78 (Bankr. S.D.N.Y. Sept. 22, 2011).

[68] *Picard v. Taylor* (*In re Park S. Sec., LLC),* 326 B.R. 505, 514 (Bankr. S.D.N.Y. 2005)

have standing to bring turnover and accounting claims pursuant to § 542 against a broker in connection with a fraudulent transfer action since the property held by a broker-dealer for the account of a customer is not property of the broker-debtor.[69]

C. The *In Pari Delicto* Doctrine

The phrase *in pari delicto* means "in equal fault," and the *in pari delicto* defense has been defined as, "The principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing."[70] The *in pari delicto* doctrine is frequently invoked in bankruptcy or receivership cases of fraudulent schemes run by corporate debtors, where third party defendants attempt to bar trustees, receivers or other successors in interest from asserting claims against them which arise from the unlawful actions of the debtor's principals. Analysis of the defense of *in pari delicto* is distinct from an analysis of whether the plaintiff has standing to pursue the cause of action in the first instance.[71]

The doctrine frequently comes into play in fraud cases where the agents of the corporate entity acted wrongfully, and a trustee or receiver files lawsuits against third parties, standing in the shoes of the corporate entity as the plaintiff. The question becomes whether the actions of

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[69] *Picard v. Merkin* (*In re Bernard L. Madoff Inv. Sec. LLC*), 440 B.R. 243, 272 (Bankr. S.D.N.Y. 2010).

[70] *Black's Law Dictionary* 806 (8th ed. 2004); *see also Casey*, 127 Cal. App. 4th at 1138 ("The doctrine of *in pari delicto* dictates that when a participant in illegal, fraudulent, or inequitable conduct seeks to recover from another participant in that conduct, the parties are deemed *in pari delicto*, and the law will aid neither, but rather, will leave them where it finds them.").

[71] *Moratzka v. Morris* (*In re Senior Cottages of Am., LLC*), 482 F.3d 997, 1003-4 (8th Cir. 2007). *But see Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991) (Second Circuit recognizes the *in pari delicto* defense as an element of standing rather than a defense that the defendant must prove.). However, in *Picard v. Madoff* (*In re Bernard L. Madoff Investment Securities LLC*), 2011 Bankr. LEXIS 3578, at *73 (Bankr. S.D.N.Y. Sept. 22, 2011), the court distinguished *Wagoner*, holding that it does not apply to the trustee's fraud claims against members of Madoff's family who were alleged to be insiders in his Ponzi scheme and fiduciaries of BLMIS. The court concluded, "it is well established that the *Wagoner* and *in pari delicto* rules do not apply to actions of fiduciaries who are insiders in the sense that they either are on the board or in management, or in some other way control the corporation." *Id*. at *73, n.86 (quotation omitted).

the agent should be imputed to the corporate entity, and whether the trustee or receiver should be barred from bringing suit due to those wrongful actions in which the trustee or receiver did not participate. The United States Supreme Court has held that state law governs whether an agent's actions may be imputed to a corporation for state law claims.[72] Therefore, an analysis of state laws of corporate agency becomes necessary to determine whether there are any applicable exceptions to whether the bad acts of the agents can and should be imputed to the corporation and its successor in interest.

1. *In Pari Delicto* Generally a Defense Against Trustee's Claims

Trustees acquire "all legal and equitable rights of the debtor as of the commencement of the case" pursuant to Bankruptcy Code § 541(a)(1), so a trustee takes the debtor's defenses as they existed at the commencement of the bankruptcy case, including the *in pari delicto* defense.[73] While the law appears to be clear in most circuits that a trustee is subject to the *in pari delicto* doctrine, there remains much criticism of the application of the *in pari delicto* doctrine to bankruptcy trustees. The criticism focuses on the sense of unfairness that an estate representative should be imposed with the fiction that a debtor is still a party in interest, when in fact the debtor has been replaced by the trustee for the purpose of trying to recover funds for those who were injured by the debtor in the first place.[74]

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[72] *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 84, 85, 87-89, 114 S. Ct. 2048, 2054 (1994).

[73] *See, e.g., Baena v. KPMG LLP*, 453 F.3d 1 (1st Cir. 2006); *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006; *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc*., 267 F.3d 340 (3d Cir. 2001).

[74] *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What is 541 Property of the Estate*, Jeffrey Davis, 21 Emory Bankr.Dev.J. 519 (2005). "The policy mandate in a bankruptcy case is… forceful because proceeds of the cause of action will go, not to the private litigant who was personally in cahoots with the defendant, but to the innocent creditors and investors." *Id*. at 542.

Although many of the same legal, equitable, and policy considerations that weigh for and against the application of the *in pari delicto* doctrine to a trustee also apply to a receiver, a receiver is not bound by § 541 of the Bankruptcy Code, so some courts have found that the *in pari delicto* doctrine does not apply to receivers.[75]

2. Ways to Defeat the *In Pari Delicto* Defense

The applicability of the *in pari delicto* defense ultimately depends on whether such a defense is appropriate under state law and that state's laws on imputation of an agent's acts to the corporate entity.[76] Generally speaking, corporate agency rules dictate that the actions and knowledge of a corporation's directors and officers will bind the corporation. However, the states have a variety of exceptions to this general rule. The question under state law then becomes whether it is appropriate to impute the actions of a director, officer, shareholder or other agent to the debtor corporation and whether exceptions exist in a particular state's laws to the basic rules of corporate agency.

The most frequently invoked exception to the general rule of imputation under state law is the **adverse interest exception**. The general rule is that the misconduct of management of the corporation will not be imputed to the corporation if the officer acted entirely in his own interests and adversely to the corporation.[77] If a plaintiff can show that the officers and directors of the debtor who participated in the fraudulent transactions were acting in their own interests and to

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[75] *See Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995); *FDIC v. O'Melveny & Meyers*, 61 F.3d 17, 19 (9th Cir. 1995) ("A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the [entity]; it is thrust into those shoes."); *Mosier v. Stonefield Josephson, Inc.,* 2011 U.S. Dist. LEXIS 124058, at *5 (C.D. Cal. Oct. 25, 2011).

[76] *O'Melveny & Myers v. FDIC*, 521 U.S. 79, 114 S.Ct. 2048, 2054 (1994) (state law governs whether an agent's actions or knowledge may be imputed to a corporation for state law claims).

[77] *USACM Liquidating Trust v. Deloitte & Touche, LLP*, 764 F. Supp.2d 1210, 1218 (D. Nev. 2011).

the detriment of the debtor, then several courts have found that the adverse interest exception defeats the *in pari delicto* doctrine.[78]

However, courts have varied in their interpretations of how to apply the adverse interest exception, establishing different benchmarks to measure and analyze the benefit to wrongdoer, the benefit to the corporation, and the adversity to the corporation. Some courts narrowly interpret the exception to mean that the guilty manager must have "totally abandoned" the interest of the principal corporation, while other courts engage in an analysis of respective benefits received by the corporate entity versus the wrongdoer insider.[79] Other courts have found that the adverse interest exception should be determined by the agent's subjective motives, rather than a strict rule of whether the debtor received any benefit as a result of the agent's activities.[80]

Often a corporation receives a benefit in the short term from the wrongful conduct of the debtor's insiders (such as borrowed or invested funds based on false financials), but the corporation later ends up in an insolvency proceeding due to that wrongful conduct. The question then becomes whether this short-term benefit constitutes a benefit to the corporation which would bar the application of the adverse interest exception to the *in pari delicto* doctrine.

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[78] *Bankruptcy Servs. Inc. v. Ernst & Young* (*In re CBI Holding Co., Inc.*), 529 F.3d 432 (2d Cir. 2008) (finding that *in pari delicto* does not apply if the fraud was not perpetrated for the benefit of the debtor corporation, but rather only for the benefit of the wrongdoer).

[79] *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008) ("[F]raudulent conduct will not be imputed if the officer's interests were adverse to the corporation and not for the benefit of the corporation."); *Baena v. KPMG, LLP,* 453 F.3d 1, 8 (1st Cir. 2006) (holding that the adverse interest exception generally applies when the agent has "totally abandoned" the interests of the corporate debtor and is acting entirely for his own purposes); *Breeden v. Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)*, 336 F.3d 94, 100 (2d Cir. 2003)(holding that the adverse interest exception applies only when the agent has "totally abandoned" the principal's interest).

[80] *CBI Holding*, 529 F.3d at 451 ("[T]he 'total abandonment' standard looks principally to the intent of the managers engaged in the misconduct"). "[T]he issue [is] whether mismanagement of [the company] was the vehicle by which [the manager] *intended* to advance his own interest or whether it was simply incidental to his continued efforts to retain some economic viability in the company." *Id.* (quotation omitted).

Many courts have found that short term benefit, even of limited duration, is enough to prevent the application of the adverse interest exception and that "the ultimate fate of [the debtor] does not decide the question of benefit.[81] However, other courts have found that this short term benefit is illusory and should not qualify as benefit to the corporation which would thereby negate the adverse interest exception.[82]

There is an exception to the adverse interest exception, known as the **"sole actor" rule**. This rule provides that if the agent principal of the debtor corporation and the principal are essentially one and the same, then the misconduct of the agent principal will be imputed to the debtor corporation and *in pari delicto* will apply.[83]

Another exception to the *in pari delicto* defense, known as the **"innocent decision maker" exception**, may apply if not all of the "shareholders and/or decision makers are involved in the fraud" and, i.e., there was at least one innocent insider to whom the defendant could have reported their findings.[84] The factors applicable to this exception to the *in pari delicto* doctrine there appear to be: (1) the existence of a relevant outside decision maker; (2) who would have taken that action had he been aware of the wrongdoing; and (3) who could have taken action to

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[81] *Grede v. McGladrey & Pullen*, LLP, 2009 WL 3094850 (N.D. Ill. 2009); *Baena v. KPMG, LLP*, 453 F.3d 1, 7 (1st Cir. 2006) (finding that adverse interest exception is not automatically triggered whenever misconduct contributes to a future financial harm. If it were, it would effectively eliminate the *in pari delicto* altogether, since unmasked frauds resulting in lawsuits rarely, if ever, benefit a company in the long run").

[82] *CBI Holding*, 529 F.3d 451, 453 ("Prolonging a corporation's existence in the face of ever increasing insolvency may be 'doing no more than keeping the enterprise perched at the brink of disaster.'") (citations omitted).

[83] *See In re NM Holding Co., LLC*, 622 F.3d 613, 620-21 (6th Cir. 2010); *Grassmueck v. Am. Shorthorn Assoc*., 402 F.2d 833, 838 (8th Cir. 2005) ("[W]here the principal and agent are alter egos, there is no reason to apply an adverse interest exception to the normal rules imputing the agent's knowledge to the principal, because 'the party that should have been informed [of the fraudulent conduct] was the agent itself albeit in its capacity as principal."); *Breeden v. Kirkpatrick & Lockhard LLP* (*In re Bennett Funding Group*), 336 F.3d 94, 100 (2d Cir. 2003).

[84] *SIPC v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) (finding that *in pari delicto* does not apply where innocent decision-makers who were "ignorant of the ongoing fraud and could and would if advised of the facts . . . have taken steps to bring the fraudulent conduct to an end.") (quotation omitted); *but see CBI Holding*, 529 F.3d at 432 (finding innocent insider exception invalid).

stop the wrongdoing.[85] However, some courts have found the innocent decision maker exception inapplicable even where an innocent member of management "could and would have prevented the fraud had they been aware of it."[86]

Some courts have also permitted a trustee to pursue claims against third parties despite the *in pari delicto* doctrine where the trustee is pursuing claims assigned to him by creditors. Courts have found the claims clean of the *in pari delicto* doctrine where, for example, a litigation trust is created pursuant to a plan of reorganization and the creditors opt in to the trust by assigning their litigation claims to the litigation trustee, thereby preserving the purity of the claims.[87] The Fourth Circuit has expressly found that the *in pari delicto* doctrine is not applicable where a trustee is suing on behalf of the estate as an assignee of creditors.[88]

Other courts appear to have created a special exception to the *in pari delicto* doctrine for auditors and have allowed a receiver's or trustee's claims to proceed against an auditor when the auditor was engaged in negligent or collusive behavior. The New Jersey Supreme Court held that the *in pari delicto* doctrine does not bar a negligence claim against a corporation's

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[85] *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 710 (S.D.N.Y. 2001) ("Only management that exercises total control over the corporation – or that exercises total control over the type of transactions involved in the particular fraudulent activity at issue – are relevant."); *see also Smith v. Andersen, LLP*, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001) (noting that, in "cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of an 'innocent member… of management who would have been able to prevent the fraud had he known about it.").

[86] *CBI Holding*, 311 B.R. 350, 372 (Bankr. S.D.N.Y. 2004), *aff'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008) ("[W]here a publicly traded company has delegated to a board of directors the owners' role of hiring and supervising managers, and where that board has failed to prevent managers from committing fraud, the managers' misconduct should be imputed to the company, so as not to disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty.").

[87] *Sender v. Mann*, 423 F.Supp.2d 1155, 1174 (D. Colo. 2006) (unconditional assignment of creditors' claims into opt-in trust defeats *in pari delicto* defense).

[88] *Bogdan v. JKV Real Estate Servs.*, 414 F.3d 507, 514 (4th Cir. 2005) ("As assignee, the trustee stands in the shoes of the mortgage lenders, thereby assuming all rights and interests that the mortgage lenders have in the causes of action and becoming subject to all defenses that could have been asserted against the mortgage lenders.").

auditors.[89] The Pennsylvania Supreme Court similarly refused to apply *in pari delicto* where "the defendant materially has not dealt in good faith with the principal."[90] These courts conclude that the auditors were engaged to detect the fraud in the first place and cannot use the fraud they failed to detect to bar claims against them.[91] On the other hand, some courts place the blame on the debtor's insiders rather than the auditors and reach the opposite conclusion. "[I]f the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced."[92] The New York Court of Appeals has held that even negligent and collusive auditors can assert the *in pari delicto* defense to bar the claims against them.[93]

CONCLUSION

While it may not seem fair at first glance that a transferee of property, or a professional merely providing services for its client, who happens to be a fraudster, should be found liable upon the discovery of the fraudulent scheme, a deeper look may reveal ignored red flag warnings, knowledge of the fraud, or reckless or negligent behavior which can lead to catastrophic exposure.

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[89] *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 882-83 (N.J. 2006) (claim permitted "against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors").

[90] *Official Comm. Of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP*, 989 A.2d 313, 339 (Pa. 2010) ("This effectively forecloses an *in pari delicto* defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment.").

[91] *Thabault v. Chait*, 541 F.3d at 529 (holding that the auditor was not a victim of the agent's fraud and that "allowing the auditor to invoke the *in pari delicto* doctrine would not serve the purpose of the doctrine—to protect the innocent."); *Freeman v. BDO Seidman, LLP* (*In re E.S. Bankest, L.C.*), 2010 Bankr. LEXIS 1288, at *31 (Bankr. S.D. Fla. Apr. 6, 2010) ("BDO's agreement to detect fraud as Bankest's auditor precludes BDO from using that fraud it failed to detect to assert the imputation/ in pari delicto defense as a shield to Plaintiff's claims").

[92] *Cenco Inc. v. Seidman & Seidman,* 686 F.2d 449, 456 (7th Cir. 1982).

[93] *Kirschner v. KPMG, LLC*, 2010 WL 4116609 (S.D.N.Y.).