Liability of Professionals and Insiders in Ponzi Schemes

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INTRODUCTION

It hardly seems fair. Attorneys, accountants, auditors, brokers, sales people, and financial institutions provide professional services for their clients. They are paid for those services, and they pat themselves on the back for a job well done. When their client is later revealed as a Ponzi scheme perpetrator, a bull's eye is painted on the professional's back—the professional becomes the target of major litigation to redress the injuries to the defrauded investors.

In a Ponzi scheme, where there is little to no legitimate business operation, investments are solicited from investors to further the fraudulent enterprise, and those investments are then used to pay earlier investors. This façade—often assisted by lawyers, accountants, sales people, and others (who add an air of credibility to the operation)—induces further investments, which permits the scheme to perpetuate itself and buys time for the Ponzi scheme operator to siphon funds for personal use.

When the Ponzi scheme fails, it will likely land in either a bankruptcy or a receivership proceeding. Often, the tangible assets of the Ponzi perpetrator are long gone, having been seized by the government in a civil or criminal forfeiture proceeding, or having been embezzled and spent by the insiders of the Ponzi entity. To recover funds for the investors in a Ponzi scheme, litigation claims are brought against the professionals that assisted the Ponzi perpetrator, whether knowingly or unwittingly, and against the insiders who created and caused the fraud in the first place.

CLAIMS FOR RECOVERY AGAINST PROFESSIONALS

Much to the dismay of professionals and insiders, there are many different types of tort, statutory, and equitable theories under federal and state law on which damage claims against them can be based. In addition to fraudulent transfer claims to recover funds actually paid to a professional, which are not discussed in this article, there are a few dozen other types of claims for relief that plaintiffs can pursue. This article discusses a few of the more common theories for recovery.

Malpractice and Professional Negligence

A Ponzi perpetrator's association with a well-respected lawyer or accountant boosts the confidence of those investing in the scheme. For example, the perpetrator may ask the professional to prepare private placement memoranda or audited financial statements so that the company can distribute facially reliable financials to potential investors. Relying on data provided by the perpetrator's insiders, those professionals render the requested services, but may later find themselves targets of malpractice lawsuits given the inaccuracy of the product they produced before the fraudulent scheme collapsed.

State law malpractice claims are based on a negligence theory of liability. Under California law, the plaintiff must prove the following 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 cause[d] damage to plaintiff." *Mosier v Stonefield Josephson, Inc.* (CD Cal, Oct. 25, 2011, No. CV 11–2666 PSG (EX)) 2011 US Dist Lexis 124058, *18 (citing *Thomson v Canyon* (2011) 198 CA4th 594, 604, 129 CR3d 525, and *Carlton v Quint* (2000) 77 CA4th 690, 698, 91 CR2d 844).

Although causation must be demonstrated, reasonable reliance is not an element of a professional negligence claim under California law. *Mosier v Stonefield Josephson, supra*. Other jurisdictions, however, find that reliance is an element of a malpractice claim. See, *e.g., Seitz v Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)* (3d Cir 2006) 448 F3d 672, 680 (dismissing trustee's accounting malpractice claim because trustee produced no evidence that anyone extended credit to debtor in reliance on accountant's financial statements; therefore, there was no evidence of causation).

For attorney malpractice claims, a particular causation issue arises if the wrongful act does not relate to legal services. In one Ponzi case, the court dismissed a part of the malpractice claim in the complaint because it alleged negligence in advice that the court concluded was business advice and not legal advice. See *In re Greater Southeast Community Hosp. Corp.* (Bankr D DC 2005) 333 BR 506, 529.

Outside of the Ponzi scheme context, it is the client of the professional that usually brings a claim for malpractice, and the professional does not owe any duty to customers of its client. See, *e.g., International Strategies Group, Ltd. v Greenberg Traurig, LLP* (1st Cir 2007) 482 F3d 1. In a Ponzi case, however, when the investors of the Ponzi perpetrator client have been damaged, those nonclients may seek to bring a claim for malpractice directly against the professional. Some courts permit an investor to bring a claim against a professional when the wrongful conduct is equivalent to fraud, such as gross negligence. See, *e.g*., *Silverman v KPMG, LLP (In re Allou Distributors, Inc.)* (Bankr ED NY 2008) 395 BR 246, 259.

Negligent Misrepresentation

Auditors, accountants, attorneys, or other professionals may discover that they have inadvertently, but perhaps negligently, misrepresented certain facts on financial statements, private placement memoranda, or other financial reporting documentation on which others relied in doing business with the wrongdoing defendant. Unlike a malpractice claim, a negligent misrepresentation claim necessarily requires reliance (*Mosier v Stonefield Josephson, Inc.* (CD Cal, Oct. 25, 2011, No. CV 11–2666 PSG (EX)) 2011 US Dist Lexis 124058, *20 (citation omitted):

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

One difficulty in establishing a negligent misrepresentation claim, however, is linking the wrongful conduct of the defendant to the plaintiff (*Facciola v Greenberg Traurig LLP* (D Ariz 2011) 2011 US Dist Lexis 61785, *34 (citations omitted)):

> 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."

In the *Facciola* case, the court found that the investors were within the limited group of persons to whom the law firm owed a duty when false and misleading financial information was prepared for the purpose of soliciting investors. The complaint, however, did not adequately allege that the investors were the intended recipients or that they relied on the misleading information.

In *In re Colonial Ltd. Partnership Litig.,* the court noted that

> [t]o 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.' "

In re Colonial Ltd. Partnership Litig. (D Conn 1994) 854 F Supp 64, 92 (citations omitted). See also *Duke v Touche Ross & Co*. (SD NY 1991) 765 F Supp 69, 77 (negligent misrepresentation claim was stated by investors against accounting firm that prepared private placement memorandum; memorandum was distributed to select group of qualified investors, rather than the public at large, and firm allegedly solicited some investors).

Some courts hold that foreseeable injury may constitute grounds to support an investor's negligent misrepresentation against the Ponzi debtor's professionals. The Second Circuit has held that plaintiffs alleging negligent misrepresentation under New York law against a professional with whom they have no contractual relationship—and thus no privity giving rise to a duty—must establish the following elements (*Cromer Fin. Ltd. v Berger* (SD NY 2001) 137 F Supp 2d 452, 495 (citations omitted)):

(1) the accountant must have been aware that the reports would be used for a particular purpose; (2) in furtherance of which a known party was intended to rely; and (3) some conduct by the accountant "linking" him or her to that known party. Plaintiffs are "known parties" if they are members of "'a known group possessed of vested rights, marked by a definable limit and made up of certain components.'" An accountant owes a duty of care for services relied upon by plaintiffs who are part of a specific and identifiable group rather than "'a faceless or unresolved class of persons.'" Conduct constitutes "linking conduct" if it is "some form of direct contact between the accountant and the plaintiff, such as face-to-face conversation, the sharing of documents, or other 'substantive communication' between the parties."

Fraud

Unfortunately, in some cases, professionals may have knowingly assisted in some aspect of the fraud being perpetrated in a Ponzi scheme, often by making representations, or assisting in the making of misrepresentations, to potential investors in the scheme. To establish a claim of fraud (sometimes called "fraudulent misrepresentation") under California law, the plaintiff must prove the following elements (*Lazar v Superior Court* (1996) 12 C4th 631, 638, 49 CR2d 377):

(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.

An expression of opinion will not normally provide a basis for a fraud claim because reliance on an opinion is normally not justified. See *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 295, 37 CR3d 364. See also *Hauter v Zogarts* (1975) 14 C3d 104, 111, 120 CR 681; *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 291, 17 CR3d 26. In some circumstances, however, an expression of opinion may be treated as a representation of fact for purposes of a fraud claim. A professional opinion that is not merely a casual expression of belief but rather a deliberate affirmation of the matters stated may be regarded as a positive assertion of fact. *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51. An opinion may also serve as the basis for fraud if the person expressing the opinion either "does not honestly entertain that opinion" or has "superior knowledge or special information" about the matter. *Ogier v Pacific Oil & Gas Dev. Corp*. (1955) 132 CA2d 496, 506, 282 P2d 574.

Knowledge of the fraud on the part of the professional is a key element in imposing liability on that professional. In connection with the Bernard 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 PWC actually knew about and ignored most of these warning signs." *Stephenson v PricewaterhouseCoopers LLP* (SD NY 2011) 768 F Supp 2d 562, 573. The court noted:

[A]n unseen red flag cannot be heeded. . . . [C]ourts 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.

In addition to a misrepresentation claim, a fraudulent concealment claim may also be brought in connection with a Ponzi case. "[I]nstead of an affirmative misrepresentation, a fraud cause of action may be predicated on acts of concealment where the defendant had a duty to disclose material information." *Lerner v Fleet Bank, N.A* (2d Cir 2006) 459 F3d 273, 291 (internal quotation marks and citation omitted).

Deepening Insolvency

Trustees, receivers, and even investors may attempt to bring a claim for deepening insolvency, alleging "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." *Official Comm. of Unsecured Creditors v R.F. Lafferty & Co*. (3d Cir 2001) 267 F3d 340, 347. Some jurisdictions recognize deepening insolvency as an independent claim for relief while others use it as a measure of damages. Still other jurisdictions reject the theory outright.

In *Lafferty,* the creditors' committee brought an action against the debtor's officers, directors, and outside professionals, alleging that through mismanagement 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. The *Lafferty* court held that the creditors' committee had standing to pursue claims for deepening insolvency against the debtor's lawyers and accountants, among others, for conspiring with the debtor to fraudulently issue debtor securities as part of the Ponzi scheme.

In jurisdictions that recognize deepening insolvency as an independent tort, the following are the elements of the claim: (1) an insolvent company, (2) fraud or, sometimes, negligence (3) that causes expansion of corporate insolvency by incurring additional liabilities or by dissipating assets (4) that prolongs the life of the corporation, and (5) harm to the company that is distinct from harm to individual creditors. *Official Comm. of Unsecured Creditors v Foss (In re Felt Mfg. Co., Inc.)* (Bankr D NH 2007) 371 BR 589. Many courts have refused to extend the scope of deepening insolvency liability to negligent acts. See, *e.g., Seitz v Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)* (3d Cir 2006) 448 F3d 672, 681. However, some courts have found that negligence is sufficient to sustain a claim for deepening insolvency. See, *e.g., In re LTV Steel Co., Inc.* (Bankr ND Ohio 2005) 333 BR 397.

In addition to the requirement of either fraud or negligence, causation of damages must be established. In *Marion v TDI Inc.* (3d Cir 2010) 591 F3d 137, the Third Circuit found that no proximate causation had been established between a cash infusion into the debtor and the debtor's increased insolvency because of "intervening acts of the company's management (*i.e.,* what it chose to do with the money)." 591 F3d at 150.

A number of courts have rejected the theory of deepening insolvency as an independent claim. See, *e.g., Wooley v Faulkner (In re SI Restructuring, Inc.)* (5th Cir 2008) 532 F3d 355, 363. See also *Fehribach v Ernst & Young LLP* (7th Cir 2007) 493 F3d 905; *Trenwick Am. Litig. Trust v Ernst & Young*, LLP (Del Ch 2006) 906 A2d 168, 204, aff'd (Del 2007) 931 A2d 438 (declining to recognize cause of action for deepening insolvency, finding no obligation for a corporation to cease business and liquidate when it becomes insolvent). Other courts permit the use of the theory of deepening insolvency as a measure of damages. See, *e.g., Thabault v Chait* (3d Cir 2008) 541 F3d 512, 522; *Silverman v KPMG, LLP (In re Allou Distributors, Inc.)* (Bankr ED NY 2008) 395 BR 246, 264.

Neither California state courts nor the Ninth Circuit have expressly adopted or rejected deepening insolvency as either an independent tort or as a theory of damages. The Ninth Circuit, however, has recognized its utility as a tool for a trustee or receiver to obtain standing by alleging harm to the debtor entity. See *Smith v Arthur Anderson LLP* (9th Cir 2005) 421 F3d 989, 1004. In *Smith*, the Ninth Circuit stated (421 F3d at 1003):

> Here, the Trustee alleges that the defendants breached contracts with or duties owed to Boston Chicken, and that if they had not concealed Boston Chicken's financial condition from its outside directors and the investing public, the firm might have filed for bankruptcy more promptly. In that situation, additional assets might not have been spent on a failing business. This allegedly wrongful expenditure of corporate assets qualifies as an injury to the firm which is sufficient to confer standing upon the Trustee.

Deepening insolvency is a powerful weapon for plaintiffs because it may serve to impose extraordinary liability against a professional if that professional, for example, is found liable for the amount of the investors' principal investments in a Ponzi scheme after the wrongful conduct. See, *e.g., Freeman v BDO Seidman LLP (In re E.S. Bankest, L.C.)* (Bankr SD Fla, Apr. 6, 2010, No. 04–17602-BKC-AJC) 2010 Bankr Lexis 1288, *65 (finding that damages for $170 million in debt incurred as a result of auditor's wrongful audit activity were recoverable).

Aiding and Abetting Tort Theories

Aiding and abetting theories of recovery may provide for relief against third parties who have been involved in a fraudulent scheme. Under California law, aiding and abetting liability may be established as follows (*Casey v U.S. Bank Nat'l Ass'n* (2005) 127 CA4th 1138, 1144, 26 CR3d 401 (citation omitted)):

> 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.

The Knowledge Requirement

The first of the two elements required to establish aiding and abetting liability—knowledge (*i.e.,* the defendant's knowledge of the fraud or of the breach of fiduciary obligation)—must be demonstrated by actual knowledge. Constructive knowledge is insufficient. *Neilson v Union Bank, N.A*. (CD Cal 2003) 290 F Supp 2d 1101, 1118 ("knew or should have known" allegations were insufficient). See also *In re First Alliance Mortgage Co*. (9th Cir 2006) 471 F3d 977, 993 ("Although the California decisions on this subject may not be entirely consistent, we agree . . . that aiding and abetting liability under California law, as applied by the California state courts, requires a finding of actual knowledge, [but] not specific intent."). But see *Marcelos v Dominguez* (ND Cal, July 18, 2008, No. C 08–00056 WHA) 2008 US Dist Lexis 91155, *26 (finding actual knowledge despite plaintiff having included phrase "knew or should have known" because plaintiff pleaded facts demonstrating actual knowledge).

The *Neilson* court noted that (290 F Supp 2d at 1118 (citation omitted)):

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.

In *Casey,* the trustee did not allege that the defendant bank had actual knowledge that it was assisting a diversion of corporate funds by allowing the insiders to withdraw funds from the accounts. The court held that the complaint must allege that defendant possessed actual knowledge of the specific, primary violation. *Casey,* 127 CA4th at 1141, 1152. In an early case, the California Supreme Court explained that aiding and abetting "may fairly be construed to imply an intentional participation with knowledge of the object to be attained." *Lomita Land & Water Co. v Robinson* (1908) 154 C 36, 47, 97 P 10.

The Substantial Assistance Requirement

In addition to knowledge of the debtor's fraud or of an insider's breach of fiduciary duty, there must also be substantial assistance in the fraud, or inducement or participation in the breach of fiduciary duty. See *Sharp Int'l Corp. v State St. Bank & Trust Co. (In re Sharp Int'l Corp.)* (2d Cir 2005) 403 F3d 43, 52. "Substantial assistance" and "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.'" *Cromer Fin. Ltd. v Berger* (SD NY 2001) 137 F Supp 2d 452, 470 (citations omitted). See also *Neilson v Union Bank, N.A*. (CD Cal 2003) 290 F Supp 2d 1101, 1118 ("substantial assistance" requires a defendant's actions to have been a "substantial factor" in causing the plaintiff's injury).

Aiding and abetting theories have also been used with varying degrees of success in suing banks for their involvement with Ponzi perpetrators. California courts have found that (*Casey,* 127 CA4th at 1145):

"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.

See also *Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortg. Co.)* (9th Cir 2006) 471 F3d 977, 994 (although definition of "substantial assistance" is not clear under California law, even "ordinary business transactions" can constitute substantial assistance).

Breach of Fiduciary Claims Against Insiders

Plaintiffs often bring claims against the individuals responsible for the fraud on the basis of a breach of fiduciary duty. Fiduciary duties are imposed on directors, officers, and majority

stockholders of corporations to prohibit self-dealing by using corporate assets for personal gain. *Pepper v Litton* (1939) 308 US 295, 311. The elements necessary to establish a claim for breach of those duties 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. *Pierce v Lyman* (1991) 1 CA4th 1093, 1101, 3 CR2d 236.

The duties are owed by corporate directors, officers, and majority shareholders. See *Jones v H.F. Ahmanson & Co.* (1969) 1 C3d 93, 81 CR 592; *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 49 CR 825; *Everest Investors 8 v McNeil Partners* (2003) 114 CA4th 411, 8 CR3d 31. See also *GAB Business Servs., Inc. v Lindsey & Newsom Claim Servs., Inc*. (2000) 83 CA4th 409, 99 CR2d 665, overruled on other grounds in *Reeves v Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289. The duties are owed to the corporation and its shareholders, but not, under California law, to its creditors. *Berg & Berg Enters. LLC v Boyle* (2009) 178 CA4th 1020, 100 CR3d 875 (no general duty to creditors when corporation is operating within zone of insolvency). See also *CML v LLC* (Del 2011) 28 A3d 1037 (known as the *Bax* case) (creditors of insolvent LLC do not have standing under Delaware law to sue manager derivatively for breach of fiduciary duty, unless that right is set forth in LLC's organizational documents or in contracts with creditors).

The duties owed by directors, officers, and controlling shareholders are the duties of loyalty, good faith, and due care. *Berg & Berg Enters. LLC,* 178 CA4th at 1037; *Tritek Telecom, Inc. v Superior Court* (2009) 169 CA4th 1385, 1390, 87 CR3d 455. The duty of loyalty has been described by the Ninth Circuit as follows (*Unified W. Grocers, Inc. v Twin City Fire Ins. Co*. (9th Cir 2006) 457 F3d 1106, 1113):

> As a fiduciary, [the director's] duties to the corporation include undivided, unselfish and unqualified loyalty, unceasing effort never to profit personally at corporate expense, and unbending disavowal of any opportunity which would permit the director's private interests to clash with those of his corporation.

In a Ponzi case, the duty of loyalty is breached when a director misappropriates money from the company for his or her own personal purposes. *Fine v Sovereign Bank* (D Mass 2008) 634 F Supp 2d 126, 145.

In California, the common law fiduciary duties of corporate directors have been codified by statute. The California General Corporation Law provides that (Corp C §309(a)):

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

See *Berg & Berg Enters. LLC,* 178 CA4th at 1037.

Courts have created a business judgment rule by which to judge the reasonableness of a director's or officer's actions. As stated by the court in *Everest Investors 8 v McNeil Partners* (2003) 114 CA4th 411, 429, 8 CR3d 31 (citations and internal quotation marks omitted):

> The business judgment rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions. . . . The rule is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. . . . The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest.

See also *Lee v Interinsurance Exch.* (1996) 50 CA4th 694, 711, 57 CR2d 798; *Gaillard v Natomas Co*. (1989) 208 CA3d 1250, 1263, 256 CR 702. "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Berg & Berg Enters. LLC,* 178 CA4th at 1045 (citations omitted). The business judgment rule is also set forth in the California General Corporation Law. See Corp C §309(c).

The presumption of the business judgment rule will be satisfied, regardless of the consequences of the decision, if the process by which the fiduciary reached the decision met the following general requirements: (1) the fiduciary was not personally interested in the subject of the decision, (2) the fiduciary was informed with respect to the subject of the decision, and (3) the fiduciary rationally believed that the decision was in the best interests of the corporation. See *FDIC v Casteter* (9th Cir 1999) 184 F3d 1040, 1045; *Everest Investors 8,* 114 CA4th at 430; *Gaillard v Natomas Co., supra*.

The protection of the business judgment rule may be lost, however, if the plaintiff can prove that the director's decision was made "without reasonable inquiry, with improper motives, or as a result of a conflict of interest." *Berg & Berg Enters. LLC,* 178 CA4th at 1045 (citations omitted). See also *Everest Investors 8 v McNeil Partners, supra; Lee,* 50 CA4th at 715. If the business judgment rule presumption is overcome, then the burden shifts back to the director or officer to demonstrate the transaction was fair. See Corp C §310(a); *Gaillard,* 208 CA3d at 1273.

DEFENSES AVAILABLE TO INSIDERS AND PROFESSIONALS

In response to claims brought against them, defendants may have several defenses available. The two most common defenses raised in Ponzi and other fraudulent scheme cases are (1) lack of standing and (2) the in pari delicto doctrine.

Standing

A first line of attack by a third party defendant is often a challenge to the plaintiff's standing to bring the claim against the defendant. Standing requires (1) a cognizable injury suffered by the plaintiff that is (2) fairly traceable to the challenged actions of the defendant and (3) redressable by a court. *Lujan v Defenders of Wildlife* (1992) 504 US 555, 560, 119 L Ed 2d 351, 364, 112 S Ct 2130.

In evaluating a plaintiff's standing to bring a claim, the law distinguishes among rights depending on the character of the plaintiff (*i.e.,* a trustee, a receiver, or an individual creditor) and the type of claim being pursued. The U.S. Supreme Court has held that a bankruptcy trustee only has standing to represent 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. *Caplin v Marine Midland Grace Trust Co.* (1972) 406 US 416, 433, 32 L Ed 2d 195, 207, 92 S Ct 1679.

A trustee's standing arises from the trustee's right to pursue property of the estate under §541(a) of the Bankruptcy Code (11 USC §541(a)), which provides that "all legal or equitable interests of the debtor in property" are property of the estate. *U.S. v Whiting Pools, Inc*. (1983) 462 US 198, 205 n9, 76 L Ed 2d 515, 522 n9, 103 S Ct 2309. Property of the estate includes causes of action, and a trustee has standing to assert claims that could have been asserted by the debtor entity as of the date of the petition. *Smith v Arthur Andersen LLP* (9th Cir 2005) 421 F3d 989, 1002. If, however, a claim belongs solely to the estate's creditors, then the trustee has no standing to bring it. See *Caplin,* 406 US at 433.

In general, receivership law similarly limits a receiver's standing to pursue claims against third parties to claims that belong to the debtor entity in receivership, as distinct from individual creditors. *Mosier v Stonefield Josephson, Inc.* (CD Cal, Oct. 25, 2011, No. CV 11–2666 PSG (EX)) 2011 US Dist Lexis 124058, *7. As a corollary, a receiver cannot bring a claim if the harm was suffered by an individual creditor rather than by the receivership entity. *Williams v California 1st Bank* (9th Cir 1988) 859 F2d 664, 666.

In analyzing standing, therefore, the issue becomes one of determining who owns the claim against the third party—the debtor or the creditors. The line is not always clear, and the inquiry focuses on "whether the trustee is seeking to redress injuries to the debtor itself caused by the defendants' alleged conduct." *Smith v Arthur Andersen, supra*. One court provided the following guidelines to assist in determining whether the claim belongs to the trustee or the individual

creditors (*Buchwald v The Renco Group (In re Magnesium Corp. of Am.)* (SD NY 2009) 399 BR 722, 758):

> In deciding whether the injury was to the corporation or its creditors, the Court believes that "best practices" would call for the Court to examine to whom any allegedly breached duty was owed; what was the injury underlying the claims; who suffered the injury; who would gain from the recovery, or lose out if the recovery were awarded to a different successful plaintiff; and, to the extent different from any of the foregoing, whether *any* creditor of the debtor could assert the claim (directly or derivatively on behalf of the corporation), or just those creditors suffering a particularized injury."

This distinction is particularly difficult to draw in a Ponzi scheme case. In analyzing the standing of a receiver to pursue claims against third parties, the Seventh Circuit in *Knauer v Jonathon Roberts Fin. Grp., Inc.* (7th Cir 2003) 348 F3d 230 distinguished between the different phases of a Ponzi scheme, *i.e.,* the sales to investors versus the embezzlement by management (348 F3d at 233):

> For our purposes, it is useful to think of Ponzi schemes as being comprised of two phases. First, the schemer solicits and receives money for investment, guaranteeing high returns while doing little with the money to produce actual profits. While in this first stage, the schemer may generate some income for himself by charging a fee or paying himself a salary with the funds, this "sales" step is not the source of most of his Ponzi gains. . . . Rather, the 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. This "embezzlement" step of the Ponzi scheme depletes the Ponzi entity of resources, which are diverted to the entity's principal, the schemer.

The *Knauer* court concluded that the receiver had standing to pursue claims relating to the embezzlement phase of the Ponzi scheme, but not claims relating to the sales process. 348 F3d at 234. After the *Knauer* decision, the Sixth Circuit noted the distinction between the investors' pre-purchase claims of fraudulent inducement to invest and the receiver's post-purchase claims of dissipation of assets, and found that the receiver did not have standing to sue the debtor's brokers for identifying investors to invest in the debtor's product. See *Liberte Capital Group, LLC v Capwill* (6th Cir 2007) 248 Fed Appx 650. The *Liberte* court could not find any tangible injury to the receivership entities traceable to the brokers' misrepresentations to the investors and therefore determined that the receivership entities did not have standing to sue the brokers for misrepresentations that the brokers made to investors.

Assignment of creditors' claims to a trustee is another possible method for conferring standing upon a trustee, although somewhat challenging in the Ninth Circuit. Relying on the Supreme Court decision in *Caplin v Marine Midland Grace Trust Co., supra,* the Ninth Circuit in *Williams v California 1st Bank* (9th Cir 1988) 859 F2d 664 held that a trustee lacked standing to bring a claim despite having received an assignment of the claim, noting that the trustee cannot "collect money not owed to the estate." 859 F2d at 667. The Fourth Circuit, however, has found that a trustee may acquire standing to assert claims on behalf of the estate if he or she takes an unconditional assignment of claims from creditors. See *Logan v JKV Real Estate Servs. (In re Bogdan)* (4th Cir 2005) 414 F3d 507, 513. In *Bogdan*, the unconditional assignments did not reserve any part of the potential recovery and the assignee was to recover from the general assets of the estate on a prorata basis with all other creditors, making the trustee the real party in interest in the adversary proceeding.

The In Pari Delicto Doctrine

The phrase "in pari delicto" means "in equal fault." When a professional has been sued by the wrongdoing debtor or a successor trustee or receiver, that defendant will likely assert the in pari delicto defense to try to bar claims against it that arose from the unlawful actions of the debtor's principals. "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." *Casey v U.S. Bank Nat'l Ass'n* (2005) 127 CA4th 1138, 1143 n1, 26 CR3d 401.

The in pari delicto doctrine is based on two premises: (1) "courts should not lend their good offices to mediating disputes among wrongdoers"; and (2) "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." *Bateman Eichler, Hill Richards, Inc. v Berner* (1985) 472 US 299, 306, 86 L Ed 2d 215, 221, 105 S Ct 2622. The doctrine is limited to situations in which (1) the plaintiff, as compared with the defendant, bears at least substantially equal responsibility for the wrong he or she seeks to redress; and (2) preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest. 472 US at 311, 86 L Ed 2d at 224.

The in pari delicto doctrine may be used to defeat a claim brought by a trustee or receiver who is standing in the shoes of a wrongdoing corporate debtor. The success of the defense may depend on the character of the plaintiff. For bankruptcy trustees, most jurisdictions have held that a trustee, who under 11 USC §541(a) acquires all of the debtor's legal and equitable rights, including defenses as they existed at the commencement of the bankruptcy case, is subject to the in pari delicto defense. See *In re Crown Vantage, Inc.* (ND Cal 2003) 2003 US Dist Lexis 27980.

Although the law seems clear in most circuits that a bankruptcy trustee is subject to the in pari delicto doctrine, there is a sense of unfairness to this conclusion. Arguably, a trustee who is charged with the task of recovering funds for creditors should not be barred from pursuing claims intended to benefit those very creditors who were injured by the debtor in the first place. It is the creditors, not the wrongdoing debtor, that would benefit from the trustee's action in seeking to recover funds.

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 discussed above also apply to a receiver. Because a receiver is not bound by §541 of the Bankruptcy Code, however, some courts have found that the in pari delicto doctrine does not apply to receivers. See, *e.g.*, *FDIC v O'Melveny & Meyers* (9th Cir 1995) 61 F3d 17, 19 ("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."); *Scholes v Lehman* (7th Cir 1995) 56 F3d 750; *Mosier v Stonefield Josephson, Inc.* (CD Cal, Oct. 25, 2011, No. CV 11–2666 PSG (EX)) 2011 US Dist Lexis 124058, *5.

Ways to Defeat the In Pari Delicto Defense

Analysis of the application of the in pari delicto doctrine does not stop with a determination of the nature of the plaintiff as a successor in interest to the wrongdoing debtor. State laws regarding corporate agency and the issue of whether an agent's bad acts can and should be imputed to the corporation and its successor in interest will ultimately determine the applicability of this defense. *O'Melveny & Myers v FDIC* (1994) 512 US 79, 129 L Ed 2d 67, 114 S Ct 2048.

In evaluating the in pari delicto doctrine, courts applying California law analyze corporate agency rules and whether the actions and knowledge of a corporation's directors and officers will bind the corporation in three steps. In *In re Crown Vantage, Inc.* (ND Cal 2003) 2003 US Dist Lexis 27980, *27 (citations omitted), the court described the analysis as follows:

> First, for the doctrine to apply, agents of the plaintiff corporation must have participated in the wrongdoing for which the corporation seeks to recover. . . . Second, if such agents, at the time of such participation, were acting in a manner adverse to the interests of the corporation, the so-called "adverse interest exception" applies, with the result that the actions of the agents are not imputed to the corporation. . . . Third, even if the agents of the corporation were acting in a manner adverse to the interests of the corporation, where the agents and the corporation are "one and the same," the "sole actor exception" applies to the "adverse interest exception," with the result that in pari delicto will bar the claim.

The question, therefore, is whether it is appropriate to impute the actions of a director, officer, shareholder, or other agent to the debtor corporation. In general, the acts of a corporation's agents are deemed to be the acts of the corporation. Corp C §208(b). The applicability of the in pari delicto defense will thus depend on what exceptions exist to the basic state law rules of corporate agency.

The Adverse Interest Exception

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. *USACM Liquidating Trust v Deloitte & Touche, LLP* (D Nev 2011) 764 F Supp 2d 1210, 1218. 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 the detriment of the debtor, several courts have found that the adverse interest doctrine defeats the in pari delicto doctrine. *Bankruptcy Servs. Inc. v Ernst & Young (In re CBI Holding Co., Inc.)* (2d Cir 2008) 529 F3d 432 (in pari delicto does not apply if fraud was not perpetrated for benefit of debtor corporation, but rather only for benefit of wrongdoer).

Courts have varied in their interpretations of how to apply the adverse interest exception. 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 the respective benefits received by the corporate entity and the wrongdoer insider. Variations of the adverse interest exception have developed as courts establish different benchmarks to measure and analyze the benefit to the wrongdoer and the benefit or adversity to the corporation.

Many courts have interpreted the adverse interest exception narrowly, finding that if the corporation itself received any benefit whatsoever, then the adverse interest exception does not apply and the defendant will be able to assert the in pari delicto defense. See, *e.g., Breeden v Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)* (2d Cir 2003) 336 F3d 94, 100 (holding that adverse interest exception applies only when agent has "totally abandoned" principal's interest). See also *Thabault v Chait* (3d Cir 2008) 541 F3d 512, 527; *Baena v KPMG, LLP* (1st Cir 2006) 453 F3d 1, 8 (adverse interest exception generally applies when agent has "totally abandoned" interests of corporate debtor and is acting entirely for his or her own purpose).

Other courts have found that the adverse interest exception should be determined by the agent's subjective motives, rather than by a strict rule concerning whether the debtor received any benefit from the agent's activities. The issue is whether the vehicle by which the manager intended to advance his or her own interest was mismanagement of the company, or whether mismanagement was simply incidental to the manager's continued efforts to retain some economic viability in the company. *Bankruptcy Servs. Inc.,* 529 F3d at 451.

Often a corporation receives a benefit in the short term from the wrongful conduct of the debtor's insiders, but later ends up in an insolvency proceeding as a result of that wrongful conduct. For example, new funds may be loaned to the wrongdoing company, or new investments made, which funds are received into the debtor's accounts and arguably provide a short-term benefit. The question then becomes whether these short-term benefits constitute a benefit to the corporation that would bar the application of the adverse interest exception to the in pari delicto doctrine.

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." *Grede v McGladrey & Pullen*, LLP (ND Ill 2009) 421 BR 879, 886. These courts have found that the adverse interest exception is not automatically triggered simply because the misconduct may have later resulted in financial harm to the entity. "If it were, it would effectively eliminate the *in pari delicto* doctrine altogether, since unmasked frauds resulting in lawsuits rarely, if ever, benefit a company in the long run." 421 BR at 887.

Other courts, however, have found that this short-term benefit is illusory and should not qualify as benefit to the corporation that would negate the adverse interest exception (*CBI Holding*, 529 F3d at 453 (citations omitted)):

> A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. . . . 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."

"Sole Actor" Rule as Exception to the Adverse Interest Exception

There is an exception to the adverse interest exception, known as the "sole actor" rule. If the agent of the debtor corporation and the principal are essentially one and the same, then the misconduct of the agent will be imputed to the debtor corporation and in pari delicto will apply. See *In re NM Holding Co., LLC* (6th Cir 2010) 622 F3d 613, 620.

> [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."

Grassmueck v American Shorthorn Ass'n (8th Cir 2005) 402 F3d 833, 838. See also *Breeden v Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)* (2d Cir 2003) 336 F3d 94, 100.

Another exception to the in pari delicto defense may apply if not all of the "shareholders and/or decisionmakers are involved in the fraud" and there was at least one innocent insider to whom the defendant could have reported his or her findings. *SIPC v BDO Seidman, LLP* (SD NY 1999) 49 F Supp 2d 644, 650 (citations omitted). But see *Ernst & Young v Bankruptcy Servs. (In re CBI Holding Co.)* (SD NY 2004) 311 BR 350, aff'd in part and rev'd in part on other grounds (2d Cir 2008) 529 F3d 432 (rejecting innocent-insider exception).

The factors applicable to this exception to the in pari delicto doctrine appear to be (1) the existence of a relevant outside decision-maker (2) who would have taken that action had he or she been aware of the wrongdoing and (3) who could have taken action to stop the wrongdoing.

> 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.

Breeden v Kiripatrick & Lockhart, LLP (SD NY 2001) 268 BR 704, 710. See also *Smith v Andersen LLP* (D Ariz 2001) 175 F Supp 2d 1180, 1199.

Some courts, however, have found the innocent decision-maker exception inapplicable even if an innocent member of management "could and would have prevented the fraud had they been aware of it." *Ernst & Young,* 311 BR at 372. As a policy matter, if the board of directors of a public company has failed to prevent company 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." 311 BR at 372.

Assignment of Claims to Trustee

Some courts have also permitted a trustee to pursue claims against third parties despite the in pari delicto doctrine when the trustee is pursuing claims assigned to him or her by creditors. Courts have found the claims clean of the in pari delicto doctrine when, *e.g.,* a litigation trust is created under 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. See *Sender v Mann* (D Colo 2006) 423 F Supp 2d 1155, 1174. The Fourth Circuit has held that the in pari delicto doctrine is not applicable when a trustee is suing on behalf of the estate as an assignee of creditors. In such a case, the trustee stands in the creditors' shoes and is subject to all defenses that could have been asserted against the creditors. *Bogdan v JKV Real Estate Servs.* (4th Cir 2005) 414 F3d 507, 514.

Some 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 against an auditor when the auditor was engaged in negligent or collusive behavior. The New Jersey Supreme Court has held that the in pari delicto doctrine does not bar a negligence claim against a corporation's auditors. *NCP Litig. Trust v KPMG LLP* (NJ 2006) 901 A2d 871, 873. The Pennsylvania Supreme Court similarly refused to apply in pari delicto when officers and auditors colluded to misstate the corporation's finances to the corporation's ultimate detriment. See *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v PriceWaterhouseCoopers, LLP* (Pa 2010) 989 A2d

313, 339. 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.

Other courts place the blame on the debtor's insiders rather than on 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." *Cenco Inc. v Seidman & Seidman* (7th Cir 1982) 686 F2d 449, 455. Significantly, the New York Court of Appeals recently held that even negligent and collusive auditors can assert the in pari delicto defense to bar the claims against them. *Kirschner v KPMG, LLC*, (2010) 912 NYS2d 512, 938 NE2d 941.

CONCLUSION

Although it may not seem fair at first glance that a professional merely providing services to a Ponzi perpetrator should be found liable when a Ponzi scheme unravels, a deeper look may reveal ignored red flags, knowledge of the fraud, or reckless or negligent behavior. All types of professionals must proceed with caution and heed red flag warnings that their client is perpetrating a fraud. Otherwise, they may face potentially catastrophic liability exposure.