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ALERT MEMORANDUM

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Seventh Circuit Affirms Dismissal of Bankruptcy Trustee Claims Against Auditor Based on *In Pari Delicto* Doctrine

On July 7, 2015, the United States Court of Appeals for the Seventh Circuit (the "Court") issued a decision affirming the dismissal of a bankruptcy trustee's Illinois law accounting malpractice claims against the investment funds' pre-bankruptcy auditor on the grounds of *in pari delicto*. Peterson v. McGladrey LLP, No. 14-1986, 2015 WL 4092300 (7th Cir. July 7, 2015), (the "Decision"). This decision is significant in that it establishes the potential viability of the *in pari delicto* doctrine as a defense to claims of a bankrupt estate against its pre-bankruptcy advisors and auditors even in cases where the alleged failures of the defendant professionals go beyond merely failing to discover the wrongful acts of the debtor or its pre-bankruptcy management.

Facts and Procedural History

Plaintiff is the Chapter 7 Trustee for the bankrupt estates of five mutual funds established by Gregory Bell (collectively, the "Funds"). The Funds invested most of their money in investments managed by Thomas Petters, who claimed to be financing inventory but, in fact, was operating a Ponzi scheme. Following the collapse of the Ponzi scheme in 2008 and the commencement of the Funds' bankruptcy cases, the Trustee commenced litigation against various alleged wrongdoers, including the Funds' outside auditors, in order to improve creditor recoveries in the bankruptcy. Of relevance to the appeal, while Bell first joined in the fraudulent investment scheme in 2008, it is alleged that Petters had been engaged in fraudulent activities in the two years prior as well.

The Trustee filed a Complaint against the Funds' outside auditors, McGladrey & Pullen, LLP ("McGladrey") and other affiliated entities alleging that the auditor-defendants were negligent in conducting audits of the Funds and that their failure to discover the Ponzi scheme caused the Funds to lose over $1.5 billion.[1] Pet. Defs. Withdraw Reference Ex A., Peterson v. McGladrey & Pullen, LLP, No. 10 C 274, 2010 WL 4435543, (N.D. Ill. Nov. 3, 2010), ECF No. 1. Defendants originally moved to dismiss the Complaint on the grounds that the doctrine of *in pari delicto* prevents liability because if defendants were otherwise culpable, the Funds' own wrongdoing precluded such claims. Mem. Law. Supp. Mot. Dismiss Am. Compl., Peterson v. McGladrey & Pullen, LLP, No. 10 C 274, 2010 WL 4435543, (N.D. Ill. Nov. 3, 2010), ECF No. 35.

[1] While other defendants were included in the action, the Seventh Circuit focused its analysis on the McGladrey claims as exemplary of the nature of the claims and relevant defenses implicated on appeal.

In 2010, the District Court dismissed the Complaint on the grounds of *in pari delicto*. Peterson v. McGladrey & Pullen, LLP, No. 10 C 274, 2010 WL 4435543 (N.D. Ill. Nov. 3, 2010). The Trustee appealed. On appeal, the Seventh Circuit held that (i) the auditors would not be liable to the debtors for failing to discover facts that Bell already knew prior to the bankruptcy, (ii) the scope of Bell's knowledge of Petters' fraudulent conduct prior to 2008 remained to be determined, and (iii) the filing of the bankruptcy did not preclude application of the *in pari delicto* defense under Illinois law. Peterson v. McGladrey & Pullen, LLP, 676 F.3d 594, 596–99 (7th Cir. 2012). Rather, the scope of the bankrupt estate's property under Bankruptcy Code section 541(a), including its litigation claims against its auditors, is defined by state law, which, in Illinois, would be subject to the doctrine of *in pari delicto* as a potential defense. Id. at 598-99. The case was remanded for consideration of McGladrey's defense on a complete factual record.

On remand, rather than develop a defense based on Bell's knowledge of the scope of Petters' fraud in 2006 and 2007, auditor McGladrey sought the application of the *in pari delicto* defense based on Bell's own misconduct. The defendants rested their arguments on evidence that separate from the Ponzi scheme operated by Petters, Bell committed an additional fraud on the Funds' investors by sending documents to potential investors that misleadingly described the Funds as making investments in obligations secured by "lockbox" arrangements, even though Bell knew throughout that Petters was not using such arrangements.

The District Court granted defendants' motion for summary judgment on the claims, concluding that the undisputed evidence of the Funds' involvement in the scheme and the misrepresentation of the flow of funds to potential investors were sufficient to establish that the Funds' "misconduct contributed to the Funds' losses at least as significantly as the negligence and recklessness with which the Trustee charges defendants," and therefore the doctrine of *in pari delicto* bars the Trustee from recovering from defendants. Peterson v. McGladrey & Pullen, LLP, No. 10 C 274, 2014 WL 1389478, at *4 (N.D. Ill. April 8, 2014).

The Trustee again appealed to the Seventh Circuit.

The Court's Decision

On appeal, the Trustee argued that under Illinois law, the doctrine of *in pari delicto* applies only when the plaintiff and defendant commit the same misconduct, and therefore the Funds' false statements to prospective investors could not establish a defense to the auditors' alleged malpractice in their failure to uncover Petters' fraudulent investment operations. Rejecting the Trustee's argument, the Court noted that while the Trustee cited case law that states that the doctrine applies when two parties commit or abet a single wrong, the Trustee failed to produce any case law affirmatively supporting the argument that the doctrine applies only when two parties participate in a single wrong. Peterson v. McGladrey LLP, No. 14-1986, 2015 WL 4092300, at *2 (7th Cir. July 7, 2015). While the Court stated that "Illinois regularly disallows litigation between one wrongdoer . . . and another . . . whose acts may have added to the loss or failed to reduce it," the cases cited by the Court "involve contribution or equitable apportionment" and do not directly address the doctrine of '*in pari delicto*.'" Id.

Rather, the Court looked to the two principles underlying the *in pari delicto* doctrine as articulated by the Supreme Court of the United States — that courts should not expend resources to entertain disputes among wrongdoers and that denying judicial relief to admitted wrongdoers serves as deterrence to future wrongdoing — and concluded that these "principles apply to a claim by the Funds, which raised money via deceit, against an auditor that negligently failed to detect a different person's fraud." Id. at *3.

The Court then rejected the potential public policy argument that "[f]oreclosing all liability when two parties commit distinct wrongs might seem to allow the failure of one safeguard to knock out others" such that "when one [party] turns out to be a scamp, then the other is excused from performing his own duties, and investors are left unprotected." Id. In particular, the Court noted that while the Trustee was precluded from pursuing claims against the auditor, the investors in the Funds—the parties that actually would have suffered the harm—could still bring claims against the defendants if the auditor was shown to be negligent or willfully blind. Id. In fact, such claims had been filed by individual investors, and those suits were previously stayed in favor of the Trustee's action.

Significance of the Decision

The Decision is significant in that it reinforces the viability of *in pari delicto* as a defense potentially available to pre-bankruptcy advisors to a debtor, even in cases where the claims against the outside professionals go beyond an alleged failure to discover the misconduct of the debtor's own management or owners. The *in pari delicto* defense is governed by state law, and courts have reached different conclusions as to whether it applies in specific litigation claims brought in different jurisdictions. Some courts have acknowledged the public policy arguments in favor of creating an exception to the doctrine of *in pari delicto* when a claim is brought by a Trustee standing in the shoes of a wrongdoer while still concluding that the language of the Bankruptcy Code does not provide for such an exception. See, e.g., In re Derivium Capital LLC, 716 F.3d 355, 367 (4th Cir. 2013). Other courts have created limited exceptions to the *in pari delicto* doctrine. See MF Global Holdings Ltd. v. PricewaterhouseCoopers LLP, 57 F. Supp. 3d 206, 210 (S.D.N.Y. 2014) (holding that *in pari delicto* would only apply to block the Trustee's claims against the auditor only if the claims were proven to arise out of the active, voluntary acts of the corporation's employees); Official Comm. of Unsecured

Creditors of Allegheny Health, Educ. and Research Found. v. PricewaterhouseCoopers, LLP, 607 F.3d 346, 355 (3d Cir. 2010) (conditioning the availability of the *in pari delicto* defense in the auditor-liability setting "on the auditor dealing materially in good faith with the client-principal"). The Delaware Court of Chancery also has stated recently that "defendants like auditors should be treated differently than other third parties when it comes to in pari delicto." Stewart v. Wilmington Trust SP Servs., Inc., 112 A.3d 271, 319 (Del. Ch. 2015) appeal granted, Civil Action No. 9306-VCP, 2015 WL 1898002 (Del. Ch. Apr. 27, 2015) (concluding that a limited exception to *in pari delicto* should apply where an auditor or similar defendant is alleged to have aided and abetted a breach of fiduciary duty).

The Seventh Circuit's application of the *in pari delicto* doctrine under Illinois law to dismiss the Trustee's claims against an auditor rejects the public policy arguments cited against the application of the doctrine, and rather upholds the principle that courts should not be used to further litigation brought by or on behalf of wrongdoers.

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