Investors and Employees as Relief Defendants in Investment Fraud Receiverships: Promoting Efficiency by Following the Plain Meaning of “Legitimate Claim or Ownership Interest

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STEVEN A. MEYEROWITZ
Many blame the recent economic struggles of the United States on an increase in white-collar crime and the greed of various members of the business community. In an effort to address such concerns, and appease voters, the federal government has taken numerous actions intended to improve the current economic difficulties and prevent future economic disasters.

One such action occurred on July 21, 2010, when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter, “Dodd-Frank” or the “Act”) into law. While Dodd-Frank tackles a variety of subjects in an effort to address some of the root causes of the recent economic downturn commonly known as the “Great Recession,” it is the whistleblower provisions found in the Act, and the Act’s dramatic expansion of current whistleblower protections under the Sarbanes-Oxley Act of 2002 (“SOX”), that arguably pose the greatest risks for businesses. There are steps, however, that companies can begin taking immediately to mitigate these increased risks.

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WHISTLEBLOWER BOUNTY PROVISIONS

Under Section 922 of Dodd-Frank, whistleblowers who provide the Securities and Exchange Commission (“SEC”) with “original information” that leads to an SEC enforcement action that results in monetary sanctions of more than $1 million — including amounts collected by certain other regulatory agencies in related actions — may be entitled to collect a bounty of between 10 and 30 percent of the sum recovered by the SEC and the other regulatory agencies. To qualify as “original information,” the information must be derived from the whistleblower’s independent knowledge or analysis and, with limited exceptions, cannot have already been received by the SEC from any other source. This “bounty” program is already in effect even though the SEC has — to date — issued only proposed rules implementing the program. In fact, during the first two months following the Act’s passage, the SEC reportedly fielded, on average, at least one whistleblower tip per day.

Whistleblowers are eligible to collect bounties even though they may have participated in the illegal activity unless they are actually criminally convicted of wrongdoing related to the SEC’s enforcement action. Dodd-Frank also provides that whistleblowers may remain anonymous by acting through counsel until it comes time to collect the bounty. Under the Act, the bounties are to be paid out of a newly-created “Investor Protection Fund,” which is to be funded with undistributed sanctions from other SEC cases.

The Act provides that if monetary sanctions collected by the SEC and by certain other regulatory agencies in related actions exceed $1 million, the amount of the whistleblower award must range from 10 percent to 30 percent of the aggregate amount collected, with the precise amount to be determined by the SEC in its sole discretion. In determining the amount of the award, the SEC is to consider factors such as the significance of the information to the success of the case, the degree of assistance provided by the whistleblower, and the interest of the SEC in deterring future violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In setting the award amount, the SEC is not permitted to take into account the balance of funds in the Investor Protection Fund. Determina-
tions concerning the amount of a bounty award are not appealable so long as it meets the mandate of being between 10 percent and 30 percent of the recovery.

Significantly, the Act also prohibits employers from retaliating against whistleblowers who provide information to the SEC or otherwise assist the SEC in any investigation or judicial or administrative action. Moreover, Dodd-Frank provides whistleblowers who believe that they have been retaliated against with a private right of action that an employee may pursue directly in federal court. A prevailing plaintiff may be entitled to reinstatement with the same seniority status that the individual would have had but for the discrimination, two times back pay with interest, and attorney’s fees.

It is not just publicly-traded companies that need to concern themselves with Dodd-Frank. The Act applies to all companies, whether public or private, large or small. For example, an employee of small privately-held company may bring a retaliation claim under the Act if the employee believes he or she was wrongfully terminated after informing the SEC that certain individuals at the company were engaged in illegal insider trading.

AMENDMENTS TO THE SARBANES OXLEY ACT OF 2002

In addition to creating its own whistleblower bounty program and cause of action for retaliation, the Act also significantly expands the whistleblower protection previously available under SOX. For example, prior to the Act, Section 806 of SOX, arguably prohibited only publicly-traded companies from terminating, demoting, suspending, threatening, or harassing an employee because the employee reported, to the federal government or to a supervisor, fraud against shareholders or a violation of SEC rules. Prior to the Act, some judges dismissed whistleblower cases against publicly-traded companies under SOX when the whistleblower was an employee of a subsidiary of the publicly-traded parent company, even when the parent company had few, if any, direct employees, and employed most of its personnel through subsidiaries. Likewise, cases were dismissed against non-public subsidiaries of publicly-traded companies on the grounds that the employee was not employed by a publicly-traded company. Section 922(h) of the Act
makes clear that no employer — whether it is publicly-traded or not — may take retaliatory action against an employee for reporting a violation under SOX Section 806. Moreover, the Act expands SOX whistleblower coverage to employees of nationally recognized statistical ratings organizations. Covered organizations include Moody’s Investors Service Inc., A.M. Best Company Inc., and Standard & Poor’s Ratings Service.

Under SOX, whistleblowers who believe they were retaliated against by their employers must first file a complaint with the Department of Labor and exhaust such administrative remedies before bringing an action in court. Prior to the Act, employees had 90 days to file complaints with the DOL. The Act doubles this period of time to 180 days. The Act also makes it clear that the 180 day statute of limitations period begins to toll when an employee becomes aware of a SOX violation, not on the date on which the violation occurred.

The Act also provides that an employee who brings a lawsuit against his former company for retaliating against him in violation of SOX’s whistleblower provision is entitled to a trial by jury. In addition, the Act explicitly invalidates pre-dispute arbitration agreements concerning SOX whistleblower retaliation claims. Similarly, the Act prohibits the waiver of the rights and remedies afforded by SOX’s whistleblower protection scheme “by any agreement, policy form, or condition of employment.”

PROPOSED RULES FOR IMPLEMENTING DODD-FRANK WHISTLEBLOWER PROVISIONS

On November 3, 2010, the SEC issued proposed rules to implement Section 922 of Dodd-Frank. As mandated by the Act, the SEC will issue final regulations within 270 days of its passage, or by April 17, 2011. The proposed rules seek to, among other things, address criticism that the Act creates perverse incentives for employees to go directly to the SEC with information regarding potential securities violations, rather than initially raising the issue internally pursuant to a company’s internal compliance program. With this goal in mind, Proposed Rule 21F-4(b)(7) provides that whistleblowers may — but are not required to — first report information to company compliance officers, in-house counsel and other appropriate
personnel while preserving their status as a qualified whistleblower. When making an internal report first, a whistleblower seeking to collect a bounty would then have 90 days to submit the information to the SEC and remain eligible for an award even if the company self-reported the information to the SEC. If the company failed to report the information to the SEC within a reasonable amount of time or otherwise acted in bad faith the 90 day limit would not apply.

Similarly, in a further effort not to undermine internal corporate compliance programs, Proposed Rule 21F-6 states that one of the criteria the SEC may take into account when determining a whistleblower’s award may be “whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the Commission.” Although the SEC “will consider higher percentage awards for whistleblowers who first report violations through their [company’s internal] compliance programs,” this consideration is not a requirement for an award above the 10 percent statutory minimum and “whistleblowers will not be penalized if they do not avail themselves of this opportunity for fear of retaliation or other legitimate reasons.” This could be an effective way for the SEC to encourage participation in internal compliance programs, but only if, in practice, whistleblowers received substantially the same or a greater award if they reported the violation internally than if they went straight to the SEC. Companies could still reduce the overall penalties assessed against them if they respond to the internal “whistle” by immediately contacting the SEC, commencing an internal investigation and cooperating with the SEC’s investigation. For this aspect of the program to have a chance to work, though, the SEC would have to demonstrate a clear and consistent connection between the relative size of the award and the whistleblower’s use of the employer’s internal compliance systems.

The proposed rules also expand on what is deemed “original information” for purposes of determining whether a whistleblower who provides information to the SEC is entitled to an award under the Act. The Act defines “original information” to include information that “is derived from the independent knowledge or analysis of a whistleblower.” The proposed rules make clear, however, that the whistleblower would not be
required to have direct firsthand knowledge of the information, but rather could report information obtained through his or her experiences, observations, or communications as long as they do not violate other restrictions on independent knowledge. Thus, for example, under Proposed Rule 21F-4(b)(2), a whistleblower would be deemed to have “independent knowledge” of information even if that knowledge derives from facts or other information that has been conveyed to the whistleblower by third parties.

On the other hand, some of the individuals whom the proposed rules explicitly preclude from having the “independent knowledge” required in order to be eligible for a bounty include:

(1) attorneys who obtained the information via communications that are subject to the attorney-client privilege;

(2) attorneys who obtained information (not just privileged information) as a result of the legal representation of a client;

(3) persons who obtained the information through the performance of an engagement required under the securities laws by an independent public accountant; and

(4) persons who obtained the information through a company’s internal compliance program or investigation or people with legal, compliance, supervisory, or governance responsibilities in the company who obtain such information in the expectation the company will take appropriate action.

However, an attorney, or person with the above responsibilities, or a person who learns information through a company investigation may properly become a whistleblower if the company does not disclose the information to the SEC within a reasonable time or otherwise proceeds in bad faith. Individuals who obtain information by a means or in a manner that violates applicable federal or state criminal law or who obtain information from anyone who is subject to any of the exclusions listed above are ineligible to receive a bounty.

The Proposing Release notes that an employee who learns about potential violations only because a compliance officer questions him or her
about the conduct, and not from any other source, would not be considered to have “independent knowledge.” It remains to be seen whether an employee with independent knowledge of the facts constituting the violation, but who becomes aware that those facts may constitute a violation only when he learns of an internal investigation, would be deemed to have independent knowledge of the violation for purposes of the rules. If the answer is yes, that could inhibit a full internal investigation for fear of alerting employees to a potential windfall. Further, the Proposing Release notes that a whistleblower would be credited with “voluntarily” providing information if the individual reports to the SEC after being questioned by an employer’s internal compliance staff unless the information is within the scope of a request directed to the employer by the SEC or another designated governmental authority. It is likely that if a company conducts an internal investigation in the absence of a governmental inquiry there will generally always be at least one employee who will be able to make a claim for an award, and the investigation may cause an employee to become aware of his or her opportunity for a windfall. This would seem to create the potential for a chilling effect on internal investigations in the absence of a subpoena.

The proposed rules provide broad anti-retaliation protections to whistleblowers. Proposed Rule 21F-2 extends the protections against retaliation by employers to any individual who provides information to the SEC about potential securities law violations irrespective of whether the whistleblower satisfies all of the requirements for award consideration set forth in the proposed rules. Thus, the protections against retaliation provided for by the Act will not depend on an ultimate adjudication that the conduct identified by the whistleblower constituted a securities law violation.

In Proposed Rule 21F-9, the SEC proposes a two step process for the submission of whistleblower tips to the agency. The first step would entail the submission of information either on a standard form or through the SEC’s online database. The second step would require the whistleblower to complete a separate form, signed under penalty of perjury, containing representations concerning the accuracy of the information provided and the whistleblower’s eligibility to collect a bounty.
PERVERSE EMPLOYEE INCENTIVES

The potential for large cash awards created by Dodd-Frank and the concomitant amendments to SOX incentivizes employees to bring information regarding potential violations of securities laws directly to the SEC rather than to the employer through internal channels. Moreover, the significant discussions of Dodd-Frank in the media increase the likelihood that employees are aware of this potential cash-grab. Why bother to notify one’s employer of potential securities law violations when filling out a form with the SEC could lead to a $100,000 payday?

The requirement that the information given to the SEC be “original information” increases the incentive for employees to ignore internal reporting and complaint devices, as employees might naturally be concerned that co-workers may contact the SEC first, thereby eliminating the “original” nature of the information. This incentive to report immediately any potential violation to the government may — and likely will — deeply undercut today’s ethics and compliance programs, which train employees to report wrongdoing internally first so that employers can assess and remedy any issue. Indeed, the incentives created by the Act and the proposed rules seem to fly in the face of the SEC’s past efforts to reward companies that self-report violations. Dodd-Frank and the proposed rules instead seem to drive a wedge between employers and employees and reduce the ability of employers to discover, report and correct violations. The SEC may have to consider whether or not it can continue to reduce penalties for companies that self-report if it becomes clear that most companies will no longer have the opportunity to do so.

WHAT IS AN EMPLOYER TO DO?

The perverse incentives created by passage of Dodd-Frank cannot be eliminated entirely by any company. However, companies are not completely powerless, and there are certain steps and actions that can alleviate some of the concerns created by Dodd-Frank. They include:

• Do not violate securities laws
STRATEGIC RESPONSES TO THE WHISTLEBLOWER PROVISIONS

- Review and publicize internal reporting procedures
- Vigorously investigate and take prompt corrective action
- Train managers to deal with employee complaints
- Document performance issues

Do Not Violate Securities Laws

The advice “do not violate securities laws” seems simple — and perhaps it is — but it is critical that companies remain vigilant in their compliance with the securities laws. Companies must ensure that their accounting practices meet all legal and industry requirements. Rotating the accountants performing internal audits allows new eyes to review the company’s accounting practices and, perhaps, to catch any inconsistencies and issues. Companies should verify the existence of proactive monitoring and tracking controls to identify any accounting and securities law issues and respond to them before noticed or reported by a whistleblower.

Additionally, rather than yielding to the temptation to employ creative accounting (e.g. creating costs so as to decrease the reported profits for tax purposes), companies should stress a conservative accounting approach. Certainly, companies should not place their businesses in positions of economic difficulty, but taking fewer risks means that the SEC is (a) less likely to investigate and (b) less likely to find violations of the laws.

Review and Publicize Internal Reporting Procedures

The passage of Dodd-Frank re-emphasizes the importance of robust internal reporting and compliance procedures. This is particularly true for the subsidiaries and affiliates of parent companies whose employees are now subject to the whistleblower protections under SOX.

Employee handbooks should contain detailed information about to whom and employee can report any potential accounting or securities laws issues. Employees should be encouraged, and perhaps even incentivized, to bring forward any information that may be helpful to their employers. If an employer creates a culture of compliance, in which employees feel as though their concerns will be addressed and that the company takes its
ethical responsibilities seriously, employees may well be less likely to raise complaints with the government. If periodically reminded about their employers’ reporting and complaint procedure — and if such procedures are easy to follow — employees may be more likely to make use of such procedures. For some companies it may be worthwhile to remind employees that even if they bring their complaint to the SEC they can, and should, still report it internally so that the employer can take prompt corrective action.

**Vigorously Investigate and Take Prompt Corrective Action**

Section 922 of Dodd-Frank may result in a dramatic increase in the number of violations reported to the SEC. But the SEC’s resources are limited, so the SEC should have an even greater incentive to reward companies that quickly address and remediate violations on their own by imposing less onerous penalties. Employers consequently need to make sure that corporate compliance programs can quickly and fully address potential violations. Companies must investigate complaints and potential issues quickly to determine their legitimacy and what actions should be taken (e.g. self-reporting; changing internal controls, etc.). While it may not be possible to avoid paying a penalty entirely, self-correction and cooperation with the SEC can help significantly reduce the penalty assessed against a company.¹⁰

**Train Manager to Deal with Employee Complaints**

Often, the first person to whom an employee will speak about any concern is his or her direct supervisor. Employees assume that their supervisors can bring complaints to the appropriate person. As such, it is imperative that all managers become intimately familiar with the employer’s reporting procedures and the proper way to address employee complaints. Managers who fail to become familiar with these processes or who willfully ignore them should be corrected promptly.

Managers should be able to instruct employees how to report potential issues, and who to contact (either internally or through an outside agency) to report their concerns. Additionally, managers should encourage their employees to use the employer’s processes and allay any employee concerns about retaliation or being labeled a “troublemaker.” Whistleblowers are able
to remain anonymous under Dodd-Frank and SOX. As such, employers may want to institute internal reporting and complaint processes that offer the same degree of anonymity — and managers should inform employees of the ability to complain of perceived violations anonymously.\(^{11}\)

In an effort to ensure managerial knowledge of and compliance with the employer’s reporting and complaint procedures, employers should train their managers in the company’s procedures on a regular basis and just as regularly remind them of the company’s desire to address any and all concerns. This can create a “culture of compliance” and decrease the likelihood that employees (and managers) will pursue other avenues of redress.

**Document Performance Issues**

Dodd-Frank and the amendments to SOX create wholesale retaliation protections for employees who bring information to the government. As such, employers must be able to justify any adverse employment action taken against such an employee. So in addition to a “culture of compliance,” there must be a “culture of documentation.” Employers, and their managers, often speak to employees about performance issues but fail to place a record of the conversation in a file, or an email, because they do not want to place negative information in an employee’s file. Other times, employers do not want to address a performance issue immediately because it isn’t a good time (e.g., around the holiday season). Employers need to fight the urge to be “nice” and instead document any and all employee issues. The saying “nice guys finish last” is truer than many might think.

Employees often allege that the real reason for an adverse employment action is retaliation for engaging in a protected activity (such as reporting information to the SEC). And employers typically respond to any such claim by asserting that the adverse action was taken for legitimate reasons (e.g., performance problems) that were unrelated to the employee’s protected activity. Of course, it is difficult for either party to prove the real reason for the action since that involves the “intent” of the decision-makers(s). Accordingly, it is critical for employers to be able to point to appropriate documentation showing that there were legitimate issues, those issues were communicated to the employee, and the employee was given sufficient opportunity to address the issues.
Indeed, in many instances an employer will assert that the issues which ultimately lead to the adverse employment action existed before the employee even complained about the alleged wrongdoing. However, if there is no documentation showing that the issues had in fact existed before the employee engaged in the protected activity, the employer may have difficulty establishing this fact and it may appear as though the employer only had issues with the employee after he or she had engaged in the protected activity. On the other hand, if an employer can point to documented performance issues that pre-date the protected activity, it will be in much better shape to demonstrate that the adverse action that was taken after the protected activity was not retaliatory but rather legitimate action taken based on long-standing issues.

In short, without appropriate and timely documentation of the performance, attitudinal or behavioral reasons for taking an employment action, an employer lacks the evidence to have the retaliation claims dismissed. And even if an employer eventually succeeds at trial in proving that legitimate, non-discriminatory reasons motivated an employment decision, the employer will have already expended significant sums in defending against the claim. Proper documentation is key — and cannot be overstated.

CONCLUSION

No employer action can remove the possibility of an employee bringing his or her complaint to the SEC or from later claiming retaliation as the basis for an adverse employment action. However, by taking the steps outlined above, employers can reduce the potential penalties resulting from a reported violation, insulate themselves from some of these potential harms and place themselves in better positions to deal with any future legal difficulties.

NOTES

1 Section 922 of Dodd-Frank has been codified as new Section 21F of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).
2 See Proposed Rules for Implementing the Whistleblower Provisions of


4 Under the SEC’s proposed rules, the sums awarded to whistleblowers may be reduced or eliminated to the extent that the whistleblower is required to pay penalties or directed, planned or initiated the conduct that resulted in an entity’s fines. See proposed Rule 21F-15.

5 Section 748 of Dodd-Frank, codified at Section 23 of the Commodity Exchange Act ("CEA"), establishes a parallel bounty system under the auspices of the Commodity Futures Trading Commission for persons who blow the whistle on violations of the CEA.

6 Section 806 of SOX is codified at 18 U.S.C. § 1514A.

7 Proposed Rule 21F-6; 17 C.F.R. § 240.21F-6.

8 Id.

9 Dodd-Frank § 922(a).


11 Under Section 301(4) of SOX (codified at Section 10A(m)(4) of the Exchange Act), public companies whose securities are listed on a national exchange, including NASDAQ, are already required to provide a mechanism for anonymous submission of concerns about questionable accounting or auditing matters.
Embezzlement

FRANK W. ABAGNALE

The author discusses the major forms of embezzlement and suggests steps that companies can take to detect embezzlement and to lower their risks of suffering such losses.

A purchasing agent for a major corporation set up a vendor file in his wife’s maiden name, then approved more than $1 million in company payments to her for “consulting services.” A clerk in the purchasing department, suspicious of the agent’s recent purchase of a new boat and car, discovered the scheme and turned him in.

Embezzlement, part of the broader category of “occupational fraud,” is no respecter of persons or organizations. Occupational fraud covers a wide range of dishonest behavior against organizations by employees at every level, and victim organizations are found in every industry.

In a 2010 study by the Association of Certified Fraud Examiners (“ACFE”) that analyzed almost 2000 occupational fraud cases across the globe — half of them in the United States — there was a median loss of $160,000 per incident, and 25 percent of the incidents had losses over $1 million. Occupational fraud costs an organization about five percent of its annual revenue. The median duration — from when the fraud begins to when it is discovered — is about 18 months. Given the money and time involved, it is imperative to understand what occupational fraud is, how it...
occurs, how to detect it, and how to prevent it.

Occupational fraud can be divided into three main categories: corruption, fraudulent financial statements, and misappropriation of assets. Corruption includes conflicts of interest, bribery, illegal gifts, extortion, etc., and constitutes about one-third of occupational fraud cases, with a median loss of $250,000.

Financial statement fraud involves the intentional misstatement or omission of important information on an organization’s financial reports. Although only about five percent of cases come from fraudulent financial statements, they cause median losses of over $4 million and account for 68 percent of the total reported losses. They also have the longest median duration — 27 months.

Asset misappropriation is the most common, though diverse, form of occupational fraud — almost 90 percent of the cases. However, it is the least costly, with a median loss of $135,000, and is the easiest to detect.

Asset misappropriation takes many forms, such as stealing property and cash, creating ghost employees or vendors, falsifying payroll records, altering checks, submitting fictitious expenses, etc. While the list is almost infinite, it can be divided into three major areas:

<table>
<thead>
<tr>
<th>Type of Misappropriation</th>
<th>Frequency</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraudulent disbursements of cash</td>
<td>73 percent</td>
<td>$387,000</td>
</tr>
<tr>
<td>Theft of cash receipts or cash-on-hand</td>
<td>37 percent</td>
<td>$183,000</td>
</tr>
<tr>
<td>Theft of property or information</td>
<td>16 percent</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

(Percentages exceed 100 percent because cases had schemes from more than one category.)

The industries most commonly victimized are banking/financial services, manufacturing, and government/public administration.
WHO ARE THE PERPETRATORS?

More than 80 percent of occupational fraud cases, and 95 percent of their resulting losses, come from six departments: accounting, operations, executive/upper management, sales, customer service, and purchasing, with 40 percent of cases coming from the first two departments, and 27 percent from the next two.

Two-thirds of perpetrators are male and cause twice as many losses as females. These trends are consistent even when controlling for differences in position. There is a strong relationship between a perpetrator’s position of authority and the losses caused by fraud, with the greatest losses coming from those in upper management.

More than half of all cases are committed by people between the ages of 31 and 45. Median losses rise with the age of the perpetrator, and the greatest losses overwhelmingly come from people over 60.

The vast majority of perpetrators — 86 percent — were first-time offenders.

WHY OCCUPATIONAL FRAUD OCCURS

Occupational fraud occurs when the fraud “triangle” is present — motive, opportunity, and rationalization, and effective fraud prevention controls are not in place — hotlines, management reviews, separation of duties, etc.

Another extremely importance control is the “tone” set by upper management. This is especially true in the $1 million+ fraud cases. Poor management tone includes unethical attitudes, overriding fraud safeguards, and setting unrealistic goals while excessively tying compensation to sales performance, among other things.

In addition, employees and executives who feel unfairly treated sometimes believe they can get “justice” through occupational fraud and abuse. Therefore, workplace conditions are a major component in predicting and preventing fraud.

HOW OCCUPATIONAL FRAUD IS DETECTED

While there are many means by which fraud can be detected, tips are
by far the most common and most effective method, catching nearly three times as many frauds as any other form of detection. Although employees are the most frequent source of fraud tips, customers, vendors, and competitors also provide fraud tips. Fraud reporting programs should be publicized not only to employees, but also to external entities, e.g. vendors.

Government agencies had the highest rate of detection by tips and by frauds caught through external audit. Publicly held companies tended to detect more frauds by management review and internal audit than their counterparts. Privately owned companies tended to have the fewest frauds detected by tips and the most frauds caught by accident.

<table>
<thead>
<tr>
<th>Method of Detection</th>
<th>Frequency — U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tips</td>
<td>37.8 percent</td>
</tr>
<tr>
<td>Management review</td>
<td>17.1 percent</td>
</tr>
<tr>
<td>Internal audit</td>
<td>13.7 percent</td>
</tr>
<tr>
<td>By accident</td>
<td>9.3 percent</td>
</tr>
<tr>
<td>Account reconciliation</td>
<td>6.2 percent</td>
</tr>
<tr>
<td>Document examination</td>
<td>6.2 percent</td>
</tr>
<tr>
<td>External audit</td>
<td>4.2 percent</td>
</tr>
<tr>
<td>Notified by police</td>
<td>1.9 percent</td>
</tr>
<tr>
<td>Surveillance</td>
<td>1.7 percent</td>
</tr>
<tr>
<td>IT controls</td>
<td>1.2 percent</td>
</tr>
<tr>
<td>Confession</td>
<td>.08 percent</td>
</tr>
</tbody>
</table>

Management review and internal audits are the next most common forms of detection. There are also many “behavioral red flags” that fraudsters exhibit which can alert management to the fact that the company is being swindled. These include living beyond ones’ means, having financial difficulties, unwillingness to share duties or take vacations, addiction problems, and irritability or defensiveness.
DETECTING FRAUD IN SMALL BUSINESSES

Small businesses suffer unusually high occupational fraud losses, with the median loss being $155,000. Small businesses are particularly good targets for occupational fraud because they tend to have far fewer anti-fraud controls, such as a separation of duties, than larger organizations.

While small companies may not have certain controls because of cost or lack of resources, even less expensive controls are often missing, such as management review of accounts, formal codes of conduct and anti-fraud policies.

Check tampering schemes are much more common at small organizations, as are skimming and payroll frauds. The check writing, cash collection (control over incoming mail) and payroll functions are more likely to be performed by a single individual with little management oversight.

Small businesses catch a much lower proportion of schemes through tips or internal audits than larger organizations. Only 15 percent of small businesses had a hotline in place, compared to 64 percent of larger organizations. A relatively large percentage of frauds are caught by accident at small companies — nearly twice as many as at larger organizations.

Managers and owners of small businesses should focus their control investments on the most cost-effective mechanisms, such as separation of duties, hotlines and setting an ethical tone for their employees.

HOW TO PREVENT OCCUPATIONAL FRAUD

Prevention is the best “cure” for occupational fraud, and employee education is the foundation of prevention. Employees are an organization’s top fraud detection method. They must be trained in what constitutes fraud, how it hurts everyone in the company, and how to report any questionable activity.

Tips given via hotlines are the number one means by which fraud is detected. The median loss for frauds at companies with hotlines was 59 percent smaller than those without a hotline. Organizations should implement hotlines to receive tips from both internal and external sources. Tip hotlines should allow anonymity and confidentiality. In addition, employ-
Eees should be trained to recognize the common behavioral signs that a fraud is occurring and be encouraged not to ignore these red flags.

Employee support programs are also associated with median loss reductions of more than 50 percent.

Unannounced audits are an effective tool in the fight against fraud, yet less than 30 percent of victim organizations in the study conducted surprise audits. Surprise audits’ most important benefit is psychological: To cause potential perpetrators to believe that they will be caught and prosecuted, and thus has a strong deterrent effect on potential fraudsters.

Internal controls alone are insufficient to fully prevent occupational fraud. Though it is important for organizations to have strategic and effective anti-fraud controls in place, internal controls will not prevent all fraud from occurring, nor will they detect most fraud once it begins. Vigilance is essential.

External audits are the control mechanism most widely used by organizations, but they are relatively ineffective in detecting fraud and limiting losses. Audits are clearly important and can have a strong preventative effect on fraudulent behavior, but they should not be relied upon exclusively for fraud prevention.

Also, although a company should do background checks on potential employees, these checks do little to prevent occupational fraud, since the vast majority of perpetrators — 86 percent — have never been charged with or convicted of a prior offense.

Interestingly, regular financial statement audits — the most commonly implemented control — had one of the smallest results in reducing fraud. There are certain schemes that are using more in one industry than in another. Organizations need to consider the specific fraud risks they face when deciding which controls to implement for fraud prevention and detection.¹
Lastly, the Internal Revenue Service requires that embezzlers include embezzled funds as income in their yearly income taxes. Upon returning the funds or paying restitution, the embezzler becomes eligible for a tax deduction. Failure to report embezzled funds as gross income can result in the bringing of tax evasion charges. Dealing with the IRS for the rest of their lives should be a well publicized factor to deter would-be perpetrators from defrauding their organizations.

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent Losses</th>
<th>Percent Duration</th>
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</thead>
<tbody>
<tr>
<td>Hotline</td>
<td>59 percent</td>
<td>35 percent</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>59 percent</td>
<td>17 percent</td>
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<tr>
<td>Surprise Audits</td>
<td>52 percent</td>
<td>37 percent</td>
</tr>
<tr>
<td>Fraud Training for Managers/Execs</td>
<td>50 percent</td>
<td>28 percent</td>
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<tr>
<td>Fraud Training for Employees</td>
<td>50 percent</td>
<td>28 percent</td>
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<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>47 percent</td>
<td>33 percent</td>
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<tr>
<td>Code of Conduct</td>
<td>47 percent</td>
<td>38 percent</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>40 percent</td>
<td>28 percent</td>
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<tr>
<td>Management Review</td>
<td>40 percent</td>
<td>50 percent</td>
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<tr>
<td>External Audit</td>
<td>35 percent</td>
<td>38 percent</td>
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<tr>
<td>Internal Audit/FE Department</td>
<td>31 percent</td>
<td>42 percent</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>30 percent</td>
<td>25 percent</td>
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<tr>
<td>Management Certification of F/S</td>
<td>25 percent</td>
<td>35 percent</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>25 percent</td>
<td>33 percent</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>23 percent</td>
<td>33 percent</td>
</tr>
</tbody>
</table>
Early Warning Signs of Cash Misappropriation

- Decreasing ratio of cash to credit card sales.
- Increasing accounts receivable compared with cash.
- Delayed posting of accounts receivable payments.
- Credits against individual accounts receivable
- Unexplained cash discrepancies.
- Altered or forged deposit slips.
- Customer billing and payment complaints.
- Increasing “soft” expenses, such as consulting.
- Employee home address matches a vendor’s address.
- Vendor address is a post office box or mail drop.
- Excessive voided, missing, or destroyed checks
### When “Yes” is a Red Flag

These are some of the characteristics that may influence employees to commit Financial Statement frauds and misappropriate asset.

#### Financial Statement Frauds
- Is management compensation tied closely to company value?
- Is management dominated by a single person or a small group?
- Does management display a significant disregard for regulations or controls?
- Has management restricted the auditor’s access to documents or personnel?
- Has management set unrealistic financial goals?
- Does management have any past history of illegal conduct?

#### Asset Misappropriations
- Is an employee obviously dissatisfied?
- Does that employee have a past history of dishonesty or illegal conduct?
- Does that employee have known financial pressures, such as excessive debt, bad credit or tax liens?
- Has that employee’s lifestyle or behavior changed significantly?
Occupational Fraud Prevention Checklist

The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist will help organizations test the effectiveness of their fraud prevention program.

1. Is ongoing anti-fraud training provided to all employees of the organization?
2. Is an effective fraud reporting mechanism in place?
3. Is the management climate/tone at the top one of honesty and integrity?
4. Are fraud risk assessments performed to proactively identify and mitigate the company’s vulnerabilities to internal and external fraud?
5. Are strong anti-fraud controls in place and operating effectively?
6. Does the internal audit department have adequate resources and authority to operate effectively and without undue influence from senior management?
7. Does the hiring policy include thorough fraud prevention controls?
8. Are employee support programs in place to assist employees struggling with addictions, mental/emotional health, family or financial problems?
9. Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?
10. Are anonymous surveys conducted to assess employee morale?

See 2010 ACFE “Report To The Nations” for complete lists.
RESOURCES

2010 Association of Certified Fraud Examiners “Report To The Nations”
“Effective Solutions for Combating Employee Theft — Implementing and
Managing a Fraud Hotline” by Donald L. Mullinax, ACFE 2004
http://topics.law.cornell.edu/wex/embezzlement
www.lawyershop.com
www.onlinelawyersource.com
www.diversifiedriskmanagement.com

NOTE

1 A highly recommend reading is the 2010 ACFE “Report to the Nations”
and “Effective Solutions for Combating Employee Theft — Implementing
and Managing a Fraud Hotline” by Donald L. Mullinax, ACFE 2004.
In recent years, the terms “Ponzi scheme,” “financial fraud,” and “money laundering” have become unfortunate household names. Fraudsters such as Bernard Madoff have given new meaning to the term “financial fraud,” leaving behind a trail of tears and siphoned funds. This new wave of criminal audacity has prompted both the government and private citizens into action. Victims, many of whom were forced into bankruptcy, are now filing suit against either the “plots” themselves or financial institutions that, neglecting proper oversight, have authorized transactions that facilitated these schemes. Asset hunters have teamed up with former FBI, Customs, and DEA agents to assist in tracing and recovering assets for these victims. At the same time, the U.S. government has instituted significant reforms, including a comprehensive overhaul of its existing asset forfeiture program, and further legislation to stop these fraudulent schemes before they ruin the lives of more victims. The goal: to form a united front against common foes.

The authors review recent developments in the federal government’s efforts to limit financial fraud.
THE U.S. GOVERNMENT’S REVAMPED ASSET FORFEITURE PROGRAM

Today’s asset seizure laws stem from the U.S. Department of Justice’s Asset Forfeiture Program, which Congress created in 1984 as part of the Comprehensive Crime Control Act. These laws permit the federal government to seize and acquire title to forfeited assets such as real estate, cars, boats, and other personal property. Proceeds from the sale of seized assets, which are funneled into the DOJ’s Assets Forfeiture Fund (“AFF”), are used to compensate fraud victims and to recoup the high costs of law enforcement initiatives against a rising epidemic of economic crimes. The U.S. Marshals Service administers the Asset Forfeiture Program through close collaboration with other federal law enforcement agencies in the asset forfeiture community, including the FBI, DEA, ATF, the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”), and the Department of Homeland Security.

Many reasons support the existence of a government-run asset forfeiture program. First, such programs, if effectively administered, can incapacitate the economic infrastructure of crime groups and effectively deprive wrongdoers of their “tools of the trade.” Asset forfeiture prevents the circulation and redistribution of illicitly-obtained assets to fund future criminal enterprises, and helps dismantle existing crime rings by removing the tools, cash, and products that they need to continue their exploits. Second, in any case where the offense has harmed innocent victims, such as in a Ponzi scheme, asset forfeiture can be the most effective means of recovering property to provide the victims with just compensation. Indeed, law enforcement’s top priority when it comes to disbursing forfeited property is making victims whole.\(^1\) Third, depriving wrongdoers of their ill-gotten gains serves as a form of deterrence, hampering the incentive to commit economic crime by raising the likelihood that such crime will simply not pay. Finally, asset forfeiture also serves as a form of retributive punishment, depriving wrongdoers of an expensive lifestyle, and the material goods that previously gave them leverage, prestige, and the audacity to continue to exploit unwary investors.

One asset forfeiture statute of particular importance permits the forfei-
turance of all property involved in a money laundering offense. These statutory provisions highlight the singular importance of strict compliance with U.S. anti-money laundering (‘AML’) laws. Under these provisions, all comingled proceeds — regardless of whether they comprise the part of the proceeds intended to be laundered — are subject to forfeiture. For example, when one attempts to launder the proceeds from a Ponzi scheme by comingle those assets with “clean money” from another source, or hides the money by investing it in land or in a business, all of the property involved in the offense, not just the proceeds being laundered, can be forfeited. Prosecutors tend to make heavy use of these provisions, primarily because they virtually eliminate the need to distinguish between the portion of the property traceable to the underlying offense, and the portion derived from other sources.

ENSURING COMPLIANCE WITH U.S. ANTI-MONEY LAUNDERING LEGISLATION

The heightened risks of forfeiture for violating AML laws, as well as the greater monetary sums at stake, bring to focus the importance of strict compliance with such laws. Moreover, U.S. regulators have also been tightening their grip. Recently, for example, FinCEN enacted several new regulations that will substantially increase one’s risk of prosecution for non-compliance under U.S. anti-money laundering laws.

First, FinCEN has broadened the definition of what constitutes a regulated “money services business” (or “MSB”) to include foreign money services businesses, even if they do not putatively maintain any U.S. presence. This was done to ensure “that [MSB] activity within the United States that does not involve physical presence in the United States of an MSB’s agent, agency, branch or office is directly regulated.” Hence, an MSB is now “regulated [both] by its activity and the context in which the activity occurs and not simply by its status.” Consequently, companies that conduct money services activities in the United States, “whether or not on a regular basis or as an organized business concern,” can now be prosecuted, and have legitimate operating assets forfeited, for non-compliance with strict U.S. anti-money laundering laws under the Bank Secrecy Act (“BSA”).
Second, pursuant to its rulemaking authority under the BSA, FinCEN has enacted regulations that require MSBs to file reports of suspicious transactions (known under the umbrella term “Suspicious Activities Reports,” or “SARs”) within 30 days of initial detection. Under these stringent reporting requirements, a regulated MSB — including companies conducting nominal money services businesses within the U.S. without a physical presence in the country — must report any transaction that it “knows, suspects, or has reason to suspect:” (i) involves funds derived from illegal activities or is conducted to disguise funds derived from illegal activities; (ii) is designed to evade the reporting or recordkeeping requirements of the BSA (e.g. structuring transactions to avoid currency reporting); or (iii) “has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage.”

Third, under a newly proposed FinCEN rule, regulated MSBs conducting cross-border electronic fund transmittals (“CBEFTs”) will be required to report all transactions equal to or in excess of $1,000. This is a swift departure from the current threshold amount of $10,000. If implemented, this new rule is projected to raise the number of annually reported transactions from 14 million to 750 million. By comparison, the Internal Revenue Service processed a “mere” 115 million tax returns in 2009. The increased burdens associated with the need to sort, analyze, and make sense of this voluminous data will make MSBs’ identification of truly suspect transactions more difficult, undermine operational efficiency, and substantially raise transactional costs for companies involved in this line of business. Such an arduous reporting requirement may also force enterprises that currently conduct CBEFT businesses in the U.S. to move away from use of the dollar in favor of other currencies, increase their use of cover payments, and create other significant competitive disadvantages.

Finally, the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) has further exacerbated companies’ risks of non-compliance with U.S. anti-money laundering laws. Dodd-Frank’s whistleblower provisions significantly expand incentives for whistleblowers to report suspected AML violations by promising them a substantial cash bounty. They guarantee qualified whistleblowers a 10 to 30 percent share of any monetary sanctions over $1 million, made pos-
sible by their voluntary disclosure of “original information” in furtherance of certain “covered judicial or administrative action[s]” and “related actions.” Dodd-Frank broadly defines the scope of a “covered judicial or administrative action” and “related action” so as to authorize awards for individuals who provide information in connection with successful enforcement actions brought under U.S. anti-money laundering laws.  

Dodd-Frank will undoubtedly increase the number of whistleblower reports, as it promotes a “lottery mentality” that transforms a company’s own employees into bounty hunters, incentivizing them to be constantly prowling for potentially lucrative awards. More importantly, however, companies should assess Dodd-Frank’s impact on their existing AML compliance mechanisms, as the statute’s “original information” requirement precludes whistleblower awards for information for which the company already has knowledge. This gives award-seeking whistleblowers an irresistible incentive to bypass their company’s internal compliance and ethics program and make direct reports to FinCEN and other U.S. federal regulators.

CONCLUSION

Returning assets to victims of financial crime has become a priority for the U.S. government. As government incentives such as the Asset Forfeiture Program continue to mature, the number of recoveries of money and property derived from fraud and other non-drug related offenses will increase. Thus, the prospects of compensation for victims of these crimes will continue to improve. Additionally, the U.S. government has taken strides to halt fraudulent schemes before they hatch. By imposing stricter guidelines for reporting suspicious transactions, and developing better oversight over wire and electronic fund transfers, the U.S. government is continuing to make life difficult for swindlers. However, since victim compensation can depend, in large part, on how the government investigates and successfully prosecutes an action, the timeline for recovery can be lengthy. To expedite the return of their assets and aid the government in its investigations, many victims have assembled their own team of attorneys and investigators to bring preemptive actions against the fraudster,
their accomplices, or those financial institutions that have turned a blind eye to economic crime.

Individuals like Madoff continue to be on the prowl for uninformed victims. As these criminals find more sophisticated ways to carry out their illicit schemes and shield their ill-gotten assets from forfeiture, attorneys, investigators, and the federal government will stand ready to pursue them and assist their defenseless victims. A united front is required to take down these financial scammers, who are wealthier, more sophisticated, and more cunning than the average criminal.

NOTES

1 See 18 U.S.C. § 981(e)(6) (authorizing the government to use forfeited property to provide victims with restitution in civil forfeiture cases); 21 U.S.C. § 853(i) (same, for criminal cases).
3 See, e.g., United States v. Puche, 350 F.3d 1137, 1153-54 (11th Cir. 2003) (affirming that “facilitating property” is subject to forfeiture under § 982(a)(1) to the same extent as the assets being laundered).
5 Id. (emphasis in the original) (also stating that this has “the effect of capturing national and multinational MSB operations as well as the small enterprises that competed with them,” as well as “businesses that exclusively provided MSB services [and those] that provided both financial services and unrelated products or services.”).
7 31 C.F.R. 103.18-20; see also In re Matter of Western Union Financial Services Inc., FinCEN Assessment No. 2003-02, at 3 (Mar. 6, 2003).
See id., as amended by Dodd-Frank, at § 21F(a)(5) (stating that “any appropriate department or agency of the Federal Government, acting within the scope of its jurisdiction” can institute a “related action” that is covered by the whistleblower provisions).

See id., as amended by Dodd-Frank, at § 21F(a)(3)(A).
Judge Rejects Proposed Fine in ABB FCPA Prosecution

BRUCE E. YANNETT AND AARON M. TIDMAN

The authors review recent cases in which judges have rejected proposed settlements in FCPA cases.

Judges traditionally have served a deferential role in the approval of settlement agreements between federal agencies and private parties. Over the past year, however, several judges have vocally refused to quickly sign off, and instead, have actively inserted themselves into the settlement process. This recent trend has now migrated to the realm of FCPA cases.

THE ABB LTD. CASE

On September 29, 2010, the U.S Department of Justice (“DOJ”) and the Securities and Exchange Commission (“SEC”) announced the resolution of enforcement actions against ABB Ltd. — a Swiss corporation with American Depositary Shares traded on the New York Stock Exchange — and two of its subsidiaries, ABB Inc. and ABB Ltd.-Jordan.

ABB Ltd. entered into a three-year deferred prosecution agreement (“DPA”) and agreed to the filing of a criminal information charging its Jordanian subsidiary with one count of conspiracy to commit wire fraud and...
to violate the books and records provisions of the FCPA.\(^4\) ABB Ltd. admitted that ABB Ltd.–Jordan paid more than $300,000 in kickbacks to the Iraqi government to secure contracts worth $5.9 million under the U.N.’s Oil for Food Program.\(^5\) ABB Ltd. also reached a settlement with the SEC and agreed to pay more than $39 million in disgorgement, pre-judgment interest and civil penalties.\(^6\)

ABB Inc., a U.S.-based subsidiary, pleaded guilty to a criminal information charging it with one count of violating the anti-bribery provisions of the FCPA and one count of conspiracy to violate the same provisions.\(^7\) ABB Inc. admitted that one of its business units paid $1.9 million in bribes to officials at a Mexican state-owned utility company from 1997 to 2004 in return for $81 million worth of contracts.\(^8\)

Under the terms of the DPA, the DOJ explicitly credited ABB Ltd. for “voluntarily and timely” disclosing the misconduct; for conducting “a thorough internal investigation”; for “regularly report[ing] all of its findings”; for cooperating with the ongoing investigation; and for undertaking “substantial remedial measures,” including an “enhanced compliance program.”\(^9\) Consequently, the DOJ recommended a combined fine at the lowest applicable range of the U.S. Sentencing Guidelines — $30,420,000.\(^10\)

This fine also represented an upward adjustment in the applicable culpability score based on ABB Ltd.’s alleged status as a repeat offender. In 2003, ABB Ltd. voluntarily disclosed to the DOJ and SEC that two different subsidiaries paid bribes to Nigerian oil officials, and in 2004, those subsidiaries pleaded guilty to violating the anti-bribery provisions of the FCPA. ABB Ltd.’s most recent voluntarily-disclosed misconduct occurred within five years of the Nigerian violations, qualifying ABB Ltd. as a recidivist under the U.S. Sentencing Guidelines.\(^11\)

During ABB Ltd. and ABB Inc.’s sentencing, however, Judge Lynn N. Hughes of the United States District Court for the Southern District of Texas took the DOJ, and, most likely, the defendants, by surprise by declaring that ABB Ltd. was not a recidivist because the entire corporation could not be held responsible for the rogue actions of a few individuals. He stated: “To call the whole thing corrupt because there are corrupt individuals is a misstatement of reality. [Y]ou would not call ABB Inc. a murderer because one of its employees in Australia murdered somebody,
The DOJ argued that companies have compliance programs to prevent individuals from violating the law, but Judge Hughes countered that no matter how strong the compliance program, even at the Department of Justice itself, individuals will still be able to violate the law if they choose. He said, “there is a failure rate of human beings, and no process is going to be able to anticipate who’s going to turn bad. That’s why a constructive response in ABB’s case is so significant.” Judge Hughes heavily credited ABB Ltd.’s remedial efforts after its voluntary disclosure in 2004 and thought that it weighed against punishing ABB Ltd. as a recidivist.

Judge Hughes discounted the proposed increased culpability score for repeat offenses and reduced the size of the fine by roughly $13,000,000 to $17,100,000 — a fine at the lowest end of the applicable range for non-recidivists. When the DOJ referred Judge Hughes to the U.S. Sentencing Guidelines’ standard for repeat offenders, he asked, “Do I look like a rubber stamp?”

AN INDEPENDENT JUDICIARY

Federal judges have scrutinized settlement agreements more closely in recent years, and Judge Hughes’ reduction of ABB Ltd.’s penalty is but the latest example. It should no longer be expected that judges will simply “rubber stamp” the DOJ’s recommended fines and sentences, particularly, it appears, when violations have been committed by rogue employees without any substantial support or ratification from company management. Judges may independently evaluate the weight of specific considerations such as voluntary disclosure, cooperation and remediation, which provides even more incentive for companies to ensure that they have comprehensive, effective compliance programs in place.

Private parties, moreover, should not assume that leniency will come their way. Under post-Booker Supreme Court precedent, federal district judges have substantial discretion when it comes to the imposition of criminal sentences, and the rules governing corporate liability for the acts of employees can prove draconian in practice. Although there is still controversy at the margins of corporate criminal liability doctrines, partic-
ularly on the topic of “collective scienter,”\textit{\textsuperscript{18}} \textit{respondeat superior} — under which an employee performing his or her customary duties, and intending to benefit the corporation, may cause his or her corporate employer to become liable for a criminal act — remains the bedrock rule for corporate criminal liability.\textit{\textsuperscript{19}}

The fact that the DOJ did not appeal the reduced sentence imposed against ABB Ltd. only emphasizes the deference that will be afforded to federal trial judges when it comes to sentencing matters. It warrants emphasis as well that a trial judge’s discretion may be exercised in either direction within the bounds of the law — in favor of the defendant and, as other cases have shown, in favor of a potentially heavier penalty.\textit{\textsuperscript{20}}

CONCLUSION

Rejection of plea agreements as either too lenient or too harsh are unusual, but the uncertainty such rejections generate only reinforces the importance of robust compliance programs and a quick response to allegations of impropriety in the corporate context.

NOTES

\textsuperscript{1} Many of the recent examples of judicial involvement in the settlement process stem from cases arising out of the financial crisis. In August 2010, Judge Ellen S. Huvelle refused to sign a settlement between the SEC and Citibank because she was not satisfied that the deal was fair and reasonable. Even though the SEC determined that Citibank realized a benefit of up to $123 million, it offered to settle for a fine of $75 million and cited only one individual in its complaint. \textit{See} Kara Scannell, “Judge Won’t Approve Citi-SEC Pact” The Wall Street Journal (Aug. 17, 2010), http://online.wsj.com/article/SB10001424052748704868604575433833841630548.html. (“Scannell”). One month later, Judge Huvelle agreed to sign the same settlement agreement under the condition that the SEC certify Citibank’s remedial efforts and that the $75 million would go to compensate aggrieved shareholders. Stephanie Kirchgaessner, “US Court Approves Settlement With Citi,” Financial Times (Sept. 24, 2010), http://www.ft.com/cms/s/0/15e537e6-c810-11df-ae3a-00144feab49a.html#axzz18guFU8xf.
Similarly, Judge Jed S. Rakoff refused to sign a settlement between the SEC and Bank of America for $33 million because he thought the SEC should have sought a larger fine and brought enforcement actions against individual executives. Reluctantly, Judge Rakoff later signed a new settlement agreement for $150 million, which also included certain remedial requirements. See Scannell, supra.

2 In March 2010, Judge Huvelle was the first judge to question the opaque role and significant cost of independent compliance monitors, which have been a staple in FCPA settlement agreements. See Peter Henning, “When Judges Refuse to be Rubber Stamps,” New York Times Dealbook (Mar. 22, 2010), http://dealbook.nytimes.com/2010/03/22/when-judges-refuse-to-be-rubber-stamps/.


4 See id.
5 See id.
6 See id.
7 See id.
8 Id.
10 See id. at 11.
11 See U.S. Sentencing Guidelines § 8C2.5(c)(2)(A); ABB Ltd. DPA at 11.
13 Id. at 12, 14.
14 Id.
15 Id. at 20.
16 See United States v. Booker, 543 U.S. 220 (2005) (holding that the U.S. Sentencing Guidelines were advisory and not binding on judges); see also, e.g., Gall v. United States, 552 U.S. 38 (2007) (holding that appellate courts must review trial courts’ decisions under a more discretionary “abuse of discretion” standard); Kimbrough v. United States, 552 U.S. 85 (2007) (holding that judges can depart from the Sentencing Guidelines to resolve
sentencing discrepancies related to drug offenses).

17 See, e.g., Oklahoma Press Co. v. Walling, 327 U.S. 186, 205 (1946) ("[C]orporations are not entitled to all of the constitutional protections which private individuals have in these related matters."); Hale v. Henkel, 201 U.S. 43 (1906) (holding that corporations have no privilege against self-incrimination).

18 See, e.g., United States v. Science Applications International Corp., No. 08-5385 (D.C. Cir. Dec. 3, 2010) (distinguishing “collective knowledge” instructions in criminal cases as justified by the need to “prevent corporations from evading liability by ‘compartmentaliz[ing] knowledge, subdividing the elements of specific duties and operations into smaller components.’” Slip op. at 31 (quoting United States v. Bank of New England, 821 F.2d 844, 856 (1st Cir. 1987)).

19 See New York Central & Hudson River R.R. v. United States, 212 U.S. 481 (1909); United States v. Paccione, 949 F.2d 1183 (2d Cir. 1991); Old Monastery Co. v. United States, 147 F.2d 905 (4th Cir. 1945); Zito v. United States, 64 F.2d 772 (7th Cir. 1933).

20 Judges generally honor plea agreement provisions that favor defendants or that depart from the applicable guideline range for “justifiable reasons.” See U.S. Sentencing Guidelines § 6B1.2 & Commentary.
Internal Investigations: 
*Upjohn* Warnings Are Required

ANGELO A. STIO III AND MICHAEL T. PIDGEON

As the authors explain, care taken in providing an Upjohn warning can avoid hazards for the corporation, the individuals, and counsel.

Internal investigations are fraught with peril for corporate counsel who, whether in-house or outside, must take a key role in a situation embedded with conflict. In an internal investigation an attorney is asked to act on behalf of the corporation, which may have differing interests than the directors, officers and employees through whom the corporation functions. To make matters worse, these same directors, officers and employees may be individuals who retained counsel. One of the most important steps in reducing the risk of a conflict is the so-called *Upjohn* warning, when corporate counsel is faced with the often uncomfortable task of advising individuals that counsel represents only the corporation and not the individual. Care taken in providing such a warning can avoid hazards for the corporation, the individuals, and counsel.

THE *UPJOHN* DECISION: A NEW APPLICATION OF THE ATTORNEY-CLIENT PRIVILEGE

The frequently used term “Upjohn warning” derives from *Upjohn Co. v. United States*.¹ *Upjohn* did not actually involve an issue directly related

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INTERNAL INVESTIGATIONS: UPJOHN WARNINGS ARE REQUIRED

to an Upjohn warning. Rather, Upjohn provided a flexible framework to identify when employee communications with corporate counsel qualifies as protected attorney-client exchanges.

Prior to Upjohn, the circuit courts were split between the “control group” test, which only applied the attorney-client privilege to contacts with a small group of individuals at the company necessary for rendering legal advice, or the “subject matter” test, in which application of the privilege depended on the nature of the communications.

Upjohn held that each case must be evaluated on its own facts to determine whether application of attorney-client privilege would further the underlying purpose of the privilege, which is to encourage candid communications between client and counsel for the purpose of rendering legal advice. Specifically, the court emphasized that the privilege applies when “[t]he communications concerned matters within the scope of the employees’ corporate duties, and the employees themselves were sufficiently aware that they were being questioned in order that the corporation could obtain legal advice.”

Upjohn provided more flexibility for companies by allowing them to conduct internal investigations through interviewing employees, while giving assurance that the proper notice could keep these communications confidential. However, Upjohn also created tension because only the company, not the individuals, could decide to waive the attorney-client privilege that covered such communications. This tension has made it imperative to handle the internal investigations carefully to protect the company, and for corporate counsel to protect himself.

THE RUEHLE DECISION: THE PRACTICAL CONSEQUENCE OF UPJOHN

United States v. Ruehle involves a prime example of a case that features some of the pitfalls arising from the failure to provide a proper Upjohn warning. In Ruehle, counsel represented the company and its CFO in civil securities litigations at the same time it was conducting an internal investigation into issues related to the securities litigations. During the internal investigation, counsel interviewed the CFO. The company later
waived the attorney-client privilege, and turned over the interview statement to the SEC and U.S. Attorney’s Office in a criminal investigation. When the CFO was subsequently indicted, he contended that his statement to counsel during the internal investigation was protected by the attorney-client privilege, and moved to suppress the statement from admission at trial. The CFO contended that he reasonably believed at the time of the interview that counsel represented both the company and him as an individual, and that counsel never advised the interview was on behalf of the company. Counsel, on the other hand, contended that it advised the CFO that it did not represent him individually with regard to the interview.

In the absence of any documents memorializing counsel’s provision of a proper *Upjohn* warning, the district court found that counsel failed to provide it, and the disclosure of the CFO’s statement to the government required that the statement be suppressed. The court also referred counsel to the California bar for discipline for representing two parties with conflicting interests without obtaining written consent and for failing to advise the CFO to seek separate counsel.

On appeal, the Ninth Circuit reversed the suppression order, but acknowledged the “treacherous path” corporate counsel faces when conducting an internal investigation. The Ninth Circuit further noted that although the conduct of counsel was “troubling,” it did not provide a basis for suppression of the statement.

**THE UPJOHN WARNING**

In order to reduce the risks presented by the treacherous path outlined in *Ruelhe*, before undertaking any internal investigation, counsel should both provide a proper *Upjohn* warning and contemporaneously memorialize that the warning was given. Counsel also should review the record of representation to ensure that it has not represented any director, officers or employees individually in the past and that no conflict exists. If a conflict exists or if a prior representation could confuse the witness as to the nature of corporate counsel’s representation, an *Upjohn* warning may not be sufficient. Counsel should then consider taking additional steps, including obtaining a conflict waiver or recommending the company retain indepen-
dent counsel for the witness.

Although there is no magical script, an example of an appropriate *Upjohn* warning, issued by the American Bar Association’s White Collar Crime Committee Working Group, follows:

I am a lawyer for Corporation A. I represent only Corporation A, and I do not represent you personally.

I am conducting this interview to gather facts in order to provide legal advice for Corporation A. This interview is part of an investigation to determine the facts and circumstances of X in order to advise Corporation A how best to proceed.

Your communications with me are protected by the attorney-client privilege. But the attorney-client privilege belongs solely to Corporation A, not you. That means Corporation A alone may elect to waive the attorney-client privilege and reveal our discussion to third parties. Corporation A alone may decide to waive the privilege and disclose this discussion to such third parties as federal or state agencies, at its sole discretion, and without notifying you.

In order for this discussion to be subject to the privilege, it must be kept in confidence. In other words, with the exception of your own attorney, you may not disclose the substance of this interview to any third party, including other employees or anyone outside of the company. You may discuss the facts of what happened but you may not discuss this discussion.

Do you have any questions?

Are you willing to proceed?

Although providing an appropriate *Upjohn* warning can, at times, be uncomfortable and there is a risk that a witness may not cooperate with an internal investigation, the alternative in not providing a warning is far less appealing. The risks of exposing the corporation, counsel and individuals to potential adverse claims and sanctions from not providing such a warning far outweigh any minimal benefits that could arise from providing a watered-down warning or no warning at all.
NOTES

2. *Id.* at 394.
3. 583 F.3d 600 (9th Cir. Cal. 2009).
The authors explain that the exclusive purpose of the whistleblowing procedure issued recently by the French Data Protection Authority is to report concerns in the fields of accounting, banking and financial reporting, bribery and competition issues to the exclusion of any other concerns.

The French Data Protection Authority (“CNIL”) recently released an amended version of its Authorization No. AU-004 relating to the processing of personal data in the course of whistleblowing procedures. This revision is a direct consequence of the decision rendered by the French Supreme Court (Cour de cassation) one year earlier that struck down the code of business conduct of Dassault Systèmes.

8 DECEMBER, A HISTORICAL DATE FOR WHISTLEBLOWING PROCEDURES IN FRANCE

It is no coincidence that CNIL’s new regulatory framework was made public on 8 December 2010. This date is symbolic for successive evolu-
tion of the legal framework around whistleblowing procedures in France: on 8 December 2005, CNIL issued its initial Authorization No. AU-004 after several months of debate and uncertainty as to whether such procedures could be implemented in France. On 8 December 2009, the Cour de cassation determined that Dassault Systèmes’ code of business conduct was unlawful although its scope complied textually with CNIL’s Authorization No. AU-004, the Cour de cassation giving it a more restrictive interpretation. On 8 December 2010, CNIL released an amended version of its Authorization, presenting it as a clarification to its initial framework that would lift the ambiguities or difficulties of interpretation that the Cour de cassation would have pointed out.

The decision of the Cour de cassation had significantly shaken the regime that had been carefully designed by CNIL in 2005 and adopted by more than 1,500 companies in France since then. The uncertainty that followed was calling for a rapid reaction by CNIL. Instead of acting in a rush, CNIL chose to take a year to thoroughly review the situation, including conducting intensive consultations with the industry and other stakeholders (employees’ unions, employers’ representatives, other public authorities such as Halde in charge of discriminations, etc.) and carrying out on-site controls of some of the companies that had opted for the 2005 framework. This resulted in the modification of the existing framework not only to address the issues pointed out by the Cour de cassation but also to take into account experience gathered since 2005.

THE AMBIGUITIES OF THE 2005 FRAMEWORK RAISED BY THE COUR DE CASSATION

The scope of Dassault Systèmes’ whistleblowing scheme that was challenged by unions before the Cour de cassation textually complied with the 2005 framework issued by CNIL. It was limited to concerns in the fields of accounting, banking and financial reporting and fight against bribery in line with Section 1 of Authorization No. AU-004. As envisaged by Section 3 of the Authorization, concerns in other areas were excluded except where physical integrity of an individual or a vital interest of the company was at stake. The examples were quoted by Dassault Systèmes
for this last category were even those mentioned by CNIL in its guidelines, i.e., discrimination, harassment, IP infringement, communication of confidential information, insider trading and conflict of interests.

Despite the apparent conformity of Dassault Systèmes’ scheme, the Cour de cassation determined that Dassault Systèmes had misinterpreted CNIL’s Authorization.² It ruled that a whistleblowing scheme can have one and only purpose which is to report issues in the fields of accounting, banking and financial reporting and fight against bribery. No other concerns may be reported through this channel, even where physical integrity of an individual or a vital interest of the company is at stake. In other words, the Cour de cassation considered that the exception mentioned in CNIL’s Authorization and mentioned in Dassault Systèmes’ code of conduct (threat to physical integrity, to vital interest) could not be treated as the rule (issues in the fields of accounting, banking and financial reporting and to fight against bribery). This was nothing else but an open criticism of the way CNIL had drafted the Authorization.³

The clarifications and other modifications brought by CNIL

*Narrowing the scope: reporting of issues in the fields of accounting, banking and financial reporting and to fight against bribery only*

In reply to the criticism of the Cour de cassation, CNIL has now eliminated any reference to physical integrity and vital interest from its Authorization. It is now clear that the exclusive purpose of a whistleblowing procedure under this Authorization is to report concerns in the fields of accounting, banking and financial reporting and to fight against bribery (and competition issues, see below), to the exclusion of any other concerns. All such other concerns must be reported through the other reporting channels that exist in France, e.g., through the line managers, employees’ representatives, public authorities, etc.

This means that employers can no longer mention physical integrity and vital interest in their information notice relating to the implementation of an ethics line. They should make it clear that the ethics line can only be used to report issues of accounting, banking and financial reporting and to fight against bribery (and competition issues, see below) and that all
other concerns should be reported through the other available reporting channels. Should an employee nonetheless use the ethics line to report a fact that goes beyond this scope, the personnel dedicated to the ethics line should not record any information and should invite the whistleblower to use other reporting means.4

Companies that had opted for the 2005 regime and are still mentioning physical integrity and vital interest in their information notice have six months (i.e., until 7 June 2011) to comply with the new framework, i.e., to make the necessary deletion from their information notice and to ensure that their dedicated personnel, when learning of such an issue, will not store any data and will invite the whistleblower to report differently.

RESTRICTING THE RETENTION DURATION

CNIL took the opportunity of this revision to make additional edits to its framework that were not requested by the Cour de cassation. CNIL now requires that any information that exceeds the restricted scope of the ethics line be immediately deleted or archived. Furthermore, any information falling within the scope of the ethics line should be deleted or archived within two months following the closing of the investigation if the reporting did not trigger any judicial proceedings or disciplinary sanctions. This new requirement is not subject to any transition period.

BROADENING THE SCOPE: “JAPANESE SOX” AND COMPETITION ISSUES

Since 2005, CNIL had more and more often been asked to individually authorize whistleblowing schemes that allow the reporting of competition issues. More recently, CNIL had also received some individual authorization requests when the scheme was implemented as a result of the Japanese “Financial Instrument and Exchange Act” dated of 6 June 2006 known as the “Japanese SOX”. Considering that these requests were legitimate, CNIL made the decision to extend the scope of its Authorization.

As a result, as of now, the implementation of an ethics line will be deemed legitimate if the company is either bound by French law request-
ing that certain control measures be carried out, by US SOX or by the “Japanese SOX.” If this is the case, as stated above, issues in the areas of accounting, banking and financial reporting, fight against bribery, as well as competition concerns may be reported through the ethics line.

MAINTAINING THE OTHER REQUIREMENTS

• All other requirements of the Authorization remain applicable. By way of example:
  • Although anonymous reporting is not prohibited, it should not be encouraged
  • Confidentiality regarding the identity of the whistleblower should be maintained at all times vis-à-vis the accused person
  • Employees should be properly informed of the implementation of the ethics line, including of any transfer outside of the EU to a country not ensuring an adequate level of protection of personal data; employees should be made aware of their right to access their data and ask for an update; they should also expressly be informed that the bona fide use of the ethics line cannot trigger any sanction, even if the facts prove to be inaccurate and, conversely, that the use in bad faith of the ethics line could expose them to liability and to disciplinary sanctions
  • Security measures should be implemented so as to ensure inter alia that only specifically authorized personnel has access to the data

In addition, information and consultation rights of employee representative bodies may apply before a code of conduct can be implemented in France.

Should a company wish to implement an whistleblowing scheme or similar that does not comply with any requirement of the Authorization, it may still request an individual authorization from the CNIL. This is a several months’ process that will end up by a refusal if the company cannot adduce evidence that its request to depart from the Authorization is legitimate and that adequate safeguards are implemented to ensure the protection of personal data.
WHAT’S NEXT?

One would hope that this is the final act of a three-episode story. But new laws adopted outside France could give rise to new developments, such as the new whistleblower regime of the Dodd-Frank Act which introduces cash incentives for whistleblower reporting directly to the SEC. If there is once a new decision from CNIL or Cour de cassation on such new issues, chances are that it will be on an 8th of December.

NOTES

1 Official Journal of the French Republic No. 0284, 8 December 2010, No. 95.
2 The Cour de cassation also found the scheme illegal because Dassault Systèmes failed to provide adequate information to the employees as required by the French Data Protection Act (Act No. 78-17) and the Authorization. In particular, Dassault Systèmes did not inform its employees that they had a right to access their personal information and request an update. The Cour de cassation also held that Dassault Systèmes’ code of business conduct was null and void because employees needed to get prior approval to make use of confidential information whilst confidential information was not defined precisely enough. As a result, the Cour said that this was an unjustified restriction to the employees’ freedom of speech.
3 Interestingly, it was not obvious that the Cour de cassation had jurisdiction to make such a determination on the Authorization, even indirectly. One could have thought that only the Conseil d’État, the highest administrative authority, had jurisdiction because of the nature of CNIL, an administrative authority. Although the Cour de cassation does not breathe a word on this in its decision, it seems that it considered that it had jurisdiction in its capacity as guarantor of the individual rights and liberties, hence here of the employees’ rights and liberties that were subject to restrictions.
4 CNIL is currently reviewing its FAQ in connection with the implementation of ethics line. Yann Padova, CNIL’s General Secretary, indicated on 6 December 2008 during a debate with the Cour de cassation organized by the University of Cergy-Pontoise, that the personnel of an ethics line receiving a report that would concern the economical situation of the company could forward this information to the competent services provided they themselves record and keep no information. This needs to be confirmed in the FAQ.
Saving Innocence: The Need for a Federal Common Law Rule to Protect Innocent Successors Wrongly Tainted by the Sins of Their Predecessors

ROBERT MILLER

This article provides an overview of in pari delicto, outlines the growth of the majority circuit court view, summarizes the criticism of the majority circuit view, provides evidence of why a federal common law rule is necessary, illustrates that the Supreme Court’s application of in pari delicto can provide a suitable framework for a federal common law rule, and predicts the effect of the current law on the Lehman Brothers bankruptcy and considers how it might fare under the proposed rule.

The in pari delicto doctrine plagues bankruptcy trustees and other innocent successors who bring suits on behalf of creditors against third parties for aiding and abetting breaches of fiduciary duty. The problem is well documented. Courts as well as commentators have offered many solutions. A federal common law rule is the optimal solution. The failure to focus on the beneficiaries of the suits leads to inequitable results. The proposed federal common law in this article focuses on this

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preeminent consideration. If the wrongdoers will not benefit from the innocent successor’s recovery, then in pari delicto should never be applied. In pari delicto has a place in bankruptcy law. However, it should only be used when it will serve its primary purpose of prohibiting wrongdoers from enjoying the fruits of their wrongdoing. Reliance on in pari delicto has increased exponentially in recent years and the adoption of the federal common law rule proposed by this article with finally stop the inequity.

Ponzi schemes, corporate looting, discounted sales, and securities fraud all were contributory factors to the recent financial catastrophe. The fallout has included many law suits such as the holding company supervising the dispersal of Lehman Brothers assets suing Barclays for aiding and abetting the self-dealing of Lehman officers. The complaint alleged that Lehman Brothers’ managers sold corporate assets to Barclays at a discount while Lehman was on the brink of bankruptcy. In return for the discount, the culpable managers allegedly received handsome employment contracts from Barclays.

In the past, third parties who helped insiders perpetrate similar schemes successfully evaded claims brought by bankruptcy trustees and other successors-in-interest. For instance, the Tenth Circuit barred a bankruptcy trustee’s action against a third party who aided and abetted a Ponzi scheme because the court found that the debtor had been at least as culpable in the wrongdoing as the defendant. Even though the wrongdoers were removed prior to liquidation, the court found their presence at the filing barred the trustee’s claims.

The majority of the United States Circuit Courts have followed the Tenth Circuit’s precedent and limited claims brought by the trustees or other successors-in-interest against aiders and abettors (hereinafter “majority circuit view”). The wrongdoing of “insiders” (hereinafter “wrongdoers”) is often imputed to the corporation. Since the bankruptcy estate is frozen at the time of filing, the majority circuit view holds that the removal of the wrongdoers after filing is insufficient to shed the debtor’s imputed culpability. Courts then compare the imputed fault of the wrongdoers to the defendant’s fault through in pari delicto. If the imputed fault is greater than, or equal, to the defendants, the innocent successor’s suit will be blocked. The Second Circuit restricts the innocent successor’s standing
to bring claims using a similar analysis. Hence, the majority circuit view refuses to recognize the successor-in-interest as innocent and able to bring claims on behalf of the corporation without the taint of the wrongdoers.

Academic attacks on the majority Circuit view and its accompanying rationales have been unsuccessful, so the inequity continues. The opposition can be divided into three generations. The first generation, headed by Tanvir Alam, posited that courts should bar application of *in pari delicto* to innocent successors when it is inequitable. This argument is similar to this article’s proposed common law rule but its reliance upon equity is problematic because bankruptcy courts are notoriously hesitant in exercising their equity powers. Jeffrey Davis led the second generation with his article proposing that the legislative history favors a ban of *in pari delicto*. However, as this article will show, a total ban is also inequitable because *in pari delicto* should be applied in some situations where the wrongdoers are creditors or remain employed by the debtor. Catherine E. Vance heads the third generation with her article arguing that *in pari delicto* should not be applied as a tort defense because it is not compatible with comparative negligence. Vance’s argument notes an important disconnect; however, the proposed *in pari delicto* rule is the perfect vehicle for screening beneficiaries. When wrongdoers would benefit from the innocent successors’ recovery, *in pari delicto* can force the wrongdoers to pursue a suit outside of bankruptcy.

The conflict between state law and federal bankruptcy law warrants a federal common law rule for the application of *in pari delicto*. Although federal common law is restricted by the *Erie* Doctrine, the Supreme Court has held that if sufficient conflict between the state law and federal interests exists, federal courts can create common law rules for bankruptcy. The proposed rule will help ensure that *in pari delicto* is applied to serve the goal of Chapter 7, the maximization of the value of the estate as well as the added goal of Chapter 11, the rehabilitation of the debtor. These goals should discourage courts from unnecessarily using *in pari delicto* against innocent successors because it decreases the potential size of the bankruptcy estate. Furthermore, barring an innocent successor can destroy bankruptcy priorities.

The unique nature of bankruptcy law, including the distinctions between
plaintiffs and beneficiaries as well as the frozen estate, exacerbate conflict between state law and application of *in pari delicto* in bankruptcy courts. The innocent successor brings claims in the name of the corporation for the benefit of the estate’s creditors.\(^{21}\) It is the corporation, not the creditors, who is imputed with the bad acts of wrongdoers. Yet, the current majority circuit view ignores this distinction and applies *in pari delicto* to the innocent successor, irrespective of whether the wrongdoers will benefit.\(^{22}\) Bankruptcy judges have perpetuated illogical exceptions to help stem inequity.\(^{23}\) The New Jersey Supreme Court has swung the pendulum the opposite direction with a new auditor exception to *in pari delicto* that can create inequity for defendants.\(^{24}\) Lastly, *in pari delicto* law is unsettled in many jurisdictions, thereby adding further costs to the estate by increasing certainty. This massive conflict illustrates the necessity of a common law rule for application of *in pari delicto* to trustees and other innocent successors.

The federal common law rule proposed in this article first considers whether the wrongdoers will benefit from the innocent successor’s claim. If the wrongdoers will not benefit, then *in pari delicto*’s primary goal of restricting wrongdoers’ ability to profit from their bad deeds is satisfied. Therefore, when the wrongdoers are completely removed from the picture, the innocent successor’s claims should never be barred. If the wrongdoers remain, then the courts should use an *in pari delicto* analysis. Current Supreme Court precedents applying *in pari delicto* provide an efficient and equitable framework. The first prong of the framework compares the fault of the plaintiff with the defendant’s and the second prong considers whether the application undercuts the policy justifications of the statute. The defendant must prevail on both of these prongs to bar the plaintiff’s claim.

The first part of this article provides an overview of *in pari delicto* as well as applicable agency and fiduciary duty law. The second part outlines the growth of the majority circuit view as well as its underpinnings. The third part of this article summarizes the criticism of the majority circuit view by courts and commentators as well as the shortcomings of their proposed solutions. The fourth part provides evidence of why a federal common law rule is necessary. The fifth part illustrates that the Supreme Court’s application of *in pari delicto* can provide a suitable framework for a federal common law rule. The final part of this article predicts the effect...
of the current law on the Lehman Brothers bankruptcy and considers how it might fare under the proposed rule.

OVERVIEW OF A TYPICAL CASE

Every case of aiding and abetting breaches of fiduciary duty is different, and many steps and findings must be made along the path before a trustee can bring a claim against a third party. The following section provides an overview of the checkpoints a typical case passes.

The trustee in bankruptcy, the debtor-in-possession, or a creditors’ committee has standing to bring claims against third parties under Title 11 of the United States Code (hereinafter the “Bankruptcy Code”). “The trustee…is the representative of the estate [and]…has the capacity to sue and be sued.” Furthermore, “the trustee stands in the shoes of the bankrupt corporation” and possesses standing to bring any suit the debtor could have brought, but for its bankruptcy petition. Section 541 of the Bankruptcy Code codifies the estate of the debtor as “all legal or equitable interests of the debtor in property as of the commencement of the case.” Causes of action, such as aiding and abetting a breach of fiduciary duty, are interests in property within the estate. State law, not federal law, controls the composition of the estate and therefore whether the estate includes a specific cause of action. The debtor-in-possession succeeds to analogous position to the trustee as it possesses “all the rights…and powers, and shall perform all the functions and duties…of a trustee serving in a case.” Additionally, a creditor committee can be stipulated by an agreement between the debtor and creditors to “commence and prosecute …litigation on behalf of the Debtor’s estates” after receiving the blessing of the bankruptcy court.

A trustee, debtor-in-possession, or creditor committee (hereinafter “innocent successor”) may bring a derivative claim on behalf of the debtor’s estate as long as the corporation, not the individual creditors suffered the alleged injury. The fact that creditors are the primary beneficiaries of the derivative suits does make the suits individual. In fact it “is irrelevant [that] a successfully prosecuted cause of action leads to an inflow of money to the estate that will immediately flow out again to repay credi-
Any one of these three entities, when representing the interests of the injured corporation, possesses standing to bring an action for aiding and abetting a breach of fiduciary duty. 37

Fiduciary duties are an integral part of corporate governance. A fiduciary duty results when a person possesses a duty to act for the benefit of, or provide advice to, another person including artificial persons such as corporations. 38 The scope of the duty is a direct function of the scope of the parties’ relationship. 39 The examples seen throughout this article center upon the fiduciary duty that “insiders,” 40 including directors and managers, owe to their companies. Modern corporate law embraces three categories of duties: the duty of care, the duty of loyalty, and the duty of good faith. 41 However, fiduciary duties encompass all three duties and are fact specific to the relationships and entities in question. 42 Like most torts, a breach of a fiduciary duty is actionable if the harm is proximately and legally caused by the breach. 43

The innocent successor can bring actions for aiding and abetting against third parties for breaches of fiduciary duty. 44 The corporation can bring actions against the wrongdoers for injuries caused by their breaches of fiduciary duty. 45 Analogously, “it follows that [trustee standing in the corporation’s shoes] also owns the cause of action for aiding and abetting the [wrongdoers’] breach.” 46 Most states recognize the tort of aiding and abetting a breach of fiduciary duty, 47 and it lies when four major elements are met: “(1) a breach of the fiduciary duty owed to the plaintiff; (2) defendant’s ‘substantial assistance’ provided to the fiduciary in the accomplishment of the breach; (3) defendant’s knowledge that the ‘fiduciary’s conduct constituted a breach of duty’ and (4) damages sustained as a consequence of the breach.” 48 The second element may be satisfied by the aider and abettor’s active assistance or, if the aider and abettor is a fiduciary possessing a duty to act, then a failure to act is sufficient. 49 To satisfy the third element, most courts require actual knowledge or scienter of the underlying tortious act. 50 When applied to bankruptcy, the innocent successor’s usual allegations state that “a lender learned about a breach of fiduciary duty, and, rather than ‘blowing the whistle,’ the lender proceeded to act to protect itself (to the detriment of other creditors) [or]….actually took actions or structured transactions to encourage insiders to breach
their fiduciary duties.” Many alleged aider and abettors are “gatekeepers:” third party professionals that directors may rely upon. Gatekeepers include lawyers, accountants, bankers, and advisors. These professionals may become fiduciaries of the corporation and thereby possess a duty to act in limited circumstances. The importance of the gatekeepers acting as accomplices is difficult to overstate because their services are often necessary for wrongdoers to perpetuate their breaches of fiduciary duty.

Imputation can make a corporation or principal liable for the bad deeds of its agents. The imputation doctrine protects third parties who interact with the principal’s agents by limiting the principal’s ability to hide behind his agents. Under agency, imputing an agent’s actions to a corporation requires that: (1) the actions occurred in the course of the agency relationship and (2) the actions benefited the principal. When the agent’s conduct satisfies both of these requirements, the conduct is imputed to the principal who is vicariously liable, even if the agent’s actions do not comport with the principal’s directions or wishes. For example, a Chief Financial Officer (the “CFO” and an agent of the corporation) operates a Ponzi scheme to raise extra investment for the corporation (the principal) without its consent. The CFO’s wrongdoing is imputed to the corporation because his duties encompass raising additional capital and the additional capital raised by the Ponzi scheme will benefit the corporation, even though it did not advocate the Ponzi scheme. This example illustrates that imputation incentivizes principals to carefully select agents because no matter the principal’s instructions, a wrongdoing agent’s actions may be imputed to the corporation. Imputation also encourages efficacious transmission of information and orders between the principal and the agent. The underlying rationale for imputation is that the principal is the lowest cost risk avoider because it personally selects its agents and can communicate with them. The innocent successor then inherits this liability by succeeding to all the estate’s property including causes of action and defenses. In a majority of the circuits, aiders and abettors successfully shield themselves from claims using the innocent successor’s liability together with the in pari delicto affirmative defense.

The in pari delicto affirmative defense often bars innocent successor claims for aiding and abetting breaches of fiduciary duty. In pari delicto
potior est condition defendentis is best translated as “in case of equal or mutual fault… the position of the [defending] party… is the better one.”

Thus, *in pari delicto* compares the plaintiff’s fault with the defendant’s and bars the plaintiff’s claim if the plaintiff is at least equally culpable. Courts only apply *in pari delicto* when the plaintiff’s claim arises from both the plaintiff and defendant participating in same misconduct. When aiders and abettors conspire with wrongdoers, each party will be equally culpable. Therefore, even though the aider and abettor may be a guilty party, if the bad actions of the wrongdoers are imputed to the corporation, and subsequently the innocent successor standing in the shoes of the corporation, the aider and abettor will not be liable.

After filing for bankruptcy with the wrongdoers still in place, the “adverse interest exception” represents one possibility for divesting the innocent successor’s inheritance of the fiduciary breach. The adverse interest exception defeats imputation only “if the officer’s interests were adverse to the corporation so as to wholly abandon the corporate purpose.” Therefore, the exception “cannot be invoked merely because [the agent] had a conflict of interest or because he is not acting primarily for the principal.” When the “adverse interest” exception applies, the debtor corporation, or its later innocent successor, will not be bar from suing the third party for aiding and abetting.

The “sole actor” exception limits the application of the “adverse interest” exception in cases where the principal has only a sole representative. The “sole actor exception” is derived from the proposition that a corporation must bear the responsibility for allowing an agent to act without accountability. The “sole actor” exception is more potent than its name implies because it can encompass any situation where a single decision-maker dominates, such as a unified board of directors.

The “sole actor” exception can also be subject the “innocent decision-maker” exception. Even if the “adverse interest exception” does not apply to the wrongdoer’s action or the “sole actor exception” applies, the innocent successor’s claims may not be barred as long as “the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and could have stopped it.” However, if no decision-maker can be identified, *in pari delicto* may apply. Although
the “innocent decision-maker exception” provides another way to defeat *in pari delicto*, it is the product of judicial mistake and some courts refuse to apply the exception. Its perpetuation illustrates the conflict created by inequitably applying *in pari delicto* to innocent successors. The following diagram illustrates the flows of liability when *in pari delicto* is applied to an innocent successor’s claim for aiding and abetting breaches of fiduciary duty.

Birds of a feather flock together.

*In re Adelphia Communs Corp.* provides an overview of an innocent successor’s claim for aiding and abetting breaches of fiduciary duty. The Rigas family, who held the primary management positions at Adelphia, borrowed billions of dollars from Adelphia and then tried to reduce Adelphia’s leverage by introducing equity funded through “off balance sheet” debt. The Creditors’ Committee claimed that banks and investment bankers aided and abetted these breaches of fiduciary duty through their knowledge of the breaches and subsequent failure to act. The wrongdoing of the Rigases was imputed to Adelphia and the innocent trustee who stood in the shoes of the debtor at the time of filing. Post-petition events, such as the removal of the Rigases from management, played no part in the analysis and the innocent successor’s hands remained dirty. However, the trustee could pursue his claims because exceptions to *in pari delicto* applied. The “adverse interest” exception negated the application of *in pari delicto* to looting claims. The actions of Adelphia’s outside directors upon learning of the Rigases’ breaches, including the outside-director led ouster of the Rigases, illustrated that they would have stopped the breaches of fiduciary duty had they known of them. Hence, the court
applied the innocent decision-maker exception to the rest of the claims. Although *In re Adelphia Communs. Corp.* illustrates all the steps of an *in pari delicto* case against an innocent successor, the result was far different than most cases where the creditors must sue individually because the innocent successor’s claim is barred.

Judicial economy and claim priority make innocent successors better claimants for aiding and abetting breaches of fiduciary duty than individual creditors. Creditors can pursue their claims against aiders and abettors outside of bankruptcy through class actions, but loss of enforced equal treatment of creditors and priority status in addition to extra litigation and delays, all dampen the attractiveness of this route. Many of the Bankruptcy Code’s safeguards help solve the collection action problem posed by debt collection by ensuring equal treatment of similarly situated creditors and forcing the creditors to work together to maximize the size of the estate. Without bankruptcy to enforce their unity, creditors may decide it is better to certify a class without some groups, thereby maximizing individual gains. More importantly, creditors will lose their priority status. The loss of priority status undercuts the purpose of priorities, to ensure that certain categories of claims are paid in full prior to other categories receiving any payment. Priority groups usually will not have sufficient bargaining power to broker a similarly advantageous position in a class action case. Additionally, there will be delays necessitated by more litigation and filings. The leverage of the creditors is decreased by all of these factors, making them more likely to accept a smaller settlement from the aiders and abettors than they would otherwise. The equitable safeguards, priorities, and judicial economies of bankruptcy should not be undercut by the application of *in pari delicto*.

**INEQUITY: THE MAJORITY CIRCUIT VIEW**

The majority circuits view restricts innocent successors’ claims against third parties for aiding and abetting by holding innocent successors *in pari delicto* to defendants. It relies on various rationales including a restrictive interpretation of the bankruptcy estate, cryptic legislative history, and even standing to inhibit innocent successor claims for aiding and abetting.
This portion of the article provides an overview of the rationales used by circuits to explain their often inequitable application of *in pari delicto* to innocent successors.

In *In re Hedged-Investments Assocs., Inc.*, the Tenth Circuit set the initial precedent when it barred an innocent successor’s claims using the *in pari delicto* defense.\(^91\) The claim for aiding and abetting derived from two limited partnerships funneling assets into an investment services company that doubled as a “long running Ponzi scheme.”\(^92\) The trustee tried to retrieve distributions made to a limited partner that occurred prior to the collapse of the scheme.\(^93\) The defendant subsequently invested the money in a trust for her minor children, which may have made the court more likely to bar the trustee’s attempts at recovery.\(^94\) The Tenth Circuit could have relied upon the fact that “Ms. Buchanan was induced to become a partner by way of a fraudulent scheme” and held the partnership unenforceable.\(^95\) Instead of ruling on these limited grounds, the court attacked the overambitious trustee’s argument that he was “immune to any defenses based on [the principal or his partnership’s] wrongdoing.”\(^96\) The court rebutted the trustee’s argument using § 541(a)(1) of the Bankruptcy Code. According to the court, § 541(a)(1)

\[\text{[I]mits estate property to the debtor’s interests ‘as of the commencement of the case.’ This phrase places both temporal and qualitative limitations on the reach of the bankruptcy estate. In a temporal sense, it establishes a clear-cut date after which property acquired by the debtor will normally not become property of the bankruptcy estate. (citations omitted). In a qualitative sense, the phrase establishes the estate’s rights as no stronger than they were when actually held by the debtor.}^{97}\]

Even though the trustee produced “sound reasons” for an exception, the court found that neither the Bankruptcy Code nor the legislative history backed his arguments.\(^98\) Therefore, the court barred his suit because he inherited the misconduct of the partners.\(^99\)

In *Official Committee of Unsecured Creditors v. R. F. Lafferty & Co.*,\(^100\) the Third Circuit refused to consider post-petition removal of the
wrongdoers when applying *in pari delicto*. In *Lafferty*, another Ponzi scheme issued fraudulent debt certificates which eventually culminated in the scheme’s collapse and a bankruptcy filing by the affiliated firms. The Official Creditors’ Committee sued a law firm and two financial firms who helped register the debt certificates for public offering. The majority refused to consider the post-petition removal of the wrongdoers from the debtor’s management because “[t]he plain language of section 541, however prevents courts from taking into account events that occur after the commencement of the bankruptcy case. As a result we must evaluate the *in pari delicto* defense without regard to whether the Committee is an innocent successor.”

Circuits also rely upon their interpretation of legislative history, rather than simply a narrow reading of the Bankruptcy Code. The Senate Report for § 541 stated that although it “will include chooses (sp) in action and claims by the debtor against others, it is not intended to expand the debtor’s rights against others more than they exist at the commencement of the case…. [The trustee] could take no greater rights than the debtor himself had.” The Report used the example of a debtor’s inability to resuscitate its time-barred claim simply by filing for bankruptcy. Lastly, some circuits are unwilling to overturn precedent or simply cite the mountain of decisions using *in pari delicto* to bar innocent successors.

The Second Circuit’s *Wagoner* rule inhibits standing for innocent successors “when a bankrupt corporation has joined with a third party in defrauding its creditors.” Unsurprisingly, the other circuits have criticized this rule for conflating standing requirements with the application of equitable defenses. Even the Southern District of New York proclaimed that “if this court were writing from a clean slate, it would not elevate *in pari delicto* concerns to matters of standing where the alleged injury is an injury to the corporation itself.” Nonetheless, the *Wagoner rule* is so similar to the majority rule that the Southern District of New York analyzed them together. These substantial similarities make analysis of *in pari delicto* applicable to the Second Circuit as well.
COURT-MADE OPTIONS AND COMMENTATORS’ ALTERNATIVES TO THE MAJORITY CIRCUIT VIEW

This portion of the article focuses on the courts and commentators who have rejected the majority circuit view and provided more equitable alternatives. However, each of these proposals has significant limitations. The Seventh and Ninth Circuits’ precedent suggests that they would not apply *in pari delicto* to an innocent successor if the result were inequitable. Yet, neither the Seventh nor the Ninth Circuit has specifically stated that they would use an equitable framework or common law rule to apply *in pari delicto* to an innocent successor. Judge Cohen’s dissent in *Lafferty* also provides a powerful counterpoint by seizing on the artificial distinctions inherent in the majority circuit view. However, Judge Cohen unnecessarily discounts the potential for wrongdoers to continue employment with the debtor in other cases.

Scholarly attacks against the current majority circuit view can be delineated into three separate generations. The first generation, centered on Alam’s article, posited that courts should only apply *in pari delicto* to innocent successors when the result is equitable. Although the first generation argument closely parallels the proposed common law rule, its reliance upon equity weakens the argument because bankruptcy courts are hesitant to use their equitable powers. The second generation, led by Davis’ article supports a total bar on application of *in pari delicto* to innocent successors. Courts correctly noted the possible inequity of an absolute bar if the wrongdoers remained as employees or creditors of the debtor. A later part of this article will further discuss the advantages of *in pari delicto* as a screening mechanism for bankruptcy courts. The third, and newest generation, led by Vance’s article, focuses on the *in pari delicto* doctrine at the state law level where she believes its current application is not compatible with comparative negligence. Vance’s approach is probably necessary at state level. But as will be shown hereinafter, *in pari delicto* serves a very important screening purpose in bankruptcy. Furthermore, Vance’s approach would take many years and in the interim the inequity would continue.
More Equitable Views of the Courts

The current majority circuit view can be challenged on many grounds including analogizing the treatment of innocent successors to receivers. The Seventh Circuit case of Scholes v. Lehman centered on a Ponzi scheme where a receiver successfully pursued fraudulent conveyance actions against the perpetrator’s ex-wife, favorite charities, and a lucky investor.114 Chief Judge Posner colorfully articulated the underlying principal of *in pari delicto*

that the wrongdoer must not be allowed to profit from his wrong…. That reason falls out now that Douglas has been ousted from *control of and beneficial interest* in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no longer Douglas’s evil zombies. Freed from his spell they became entitled to return of the moneys.115

Instead of focusing on the appointment of the receiver, which occurred after the bankruptcy filing at the behest of the Securities and Exchange Commission,116 Judge Posner highlighted the practical importance of the receiver’s innocence because “the defense of *in pari delicto* loses its sting when the person *in pari delicto* is eliminated.”117 More recently, the Seventh Circuit affirmed in dicta the extension of Scholes to trustees because “the trustee’s Scholes argument is convincing on the inapplicability of the *in pari delicto* doctrine.”118

In *F.D.I.C. v. O’Melveny & Myers*, the Ninth Circuit highlighted two major reasons that application of *in pari delicto* to an innocent successor is inequitable: (1) the aider and abettor receives a windfall and (2) the innocent successor cannot cure the defects of the insiders.119 Faced with applying *in pari delicto* to a receiver, the Ninth Circuit stated that while “a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party’s shoes pursuant to a court order or operation of law.”120 Otherwise, the windfall created by the application of *in pari delicto* to the innocent successor would fall upon
SAVING INNOCENCE

the aiding and abetting party. The court reasoned that application of *in pari delicto* would be equitable when both parties are equally culpable.\(^{121}\) However, it is inequitable when the plaintiff is an innocent successor acting as a fiduciary of creditors and the wrongdoers are removed from the scene.\(^{122}\) The court noted that

> [a] receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank’s assets to cure any associated defects.\(^{123}\)

This article will illuminate similarities between the proposed common law rule and the framework the Seventh Circuit uses when applying *in pari delicto* to receivers. However, neither the Seventh nor the Ninth Circuit have held that equity or a common law rule constrains application of *in pari delicto* to innocent successors in bankruptcy.

Judge Cowen’s dissent in *Lafferty* highlights the inequities of the majority opinion.\(^{124}\) First, he addressed the disconnect between the inflexibility of a statute, the Bankruptcy Code, and a flexible, highly fact-intensive equitable doctrine, *in pari delicto*.\(^{125}\) He considered the necessity of requiring the removal of the wrongdoers prior to filing as inequitable because “[e]quity does not turn on that kind of empty technicality.”\(^{126}\) Second, he noted the Supreme Court’s holding in *Segal v. Rochelle*,\(^{127}\) a case involving a trustee’s successful claim of a tax refund from a taxable year that ended post-petition. In *Segal*, the Court considered post-petition events and decided the property was so entangled in the debtor’s actions before filing and not at all linked to his fresh start.\(^{128}\) Therefore, the Court decided it was part of the estate.\(^{129}\) Cohen suggested post-petition events, specifically the removal of wrongdoers, should be considered when a court decides whether to apply *in pari delicto* to an innocent successor. Cohen then analogized that the removal of the wrongdoers was “as inevitable as that completion of the taxable year in *Segal*.”\(^{130}\) Judge Cohen’s dissent is extremely valuable because it helped spark debate about application of *in pari delicto* to innocent successors. However, unlike *Lafferty*, in
many Chapter 11 cases where the debtors’ management remains as part of the debtor-in-possession, the removal of the wrongdoers is not inevitable. This point is further discussed hereinafter.

Commentators’ Proposals

Alam’s article is firmly anchored in equitable principals. According to Alam, state law should control the breadth of the debtor’s estate. However, even if the estate contains the in pari delicto defense, the doctrine should not be used for inequitable ends. He criticized the artificial distinction of whether the wrongdoers are removed prior to filing. According to Alam, the real distinction is that “the ‘scoundrels’ are gone,” and will not recover. Hence, Alam urges a balancing of the equities without consideration of when the wrongdoers were removed. This approach is very similar to the proposed rule of this article but this article suggests solving the problem through a federal common law rule.

Alam makes many salutary points about the removal of the wrongdoers from positions within the debtor. He does not directly comment on the problem of the wrongdoers as creditors but it is not a difficult leap from barring the wrongdoers from benefiting in one context, as employees, to barring them from benefiting in a parallel context as creditors. The primary difference between Alam’s rule and the proposed federal common law rule is Alam’s reliance on equity. Bankruptcy courts are courts of equity. However, bankruptcy courts have historically exhibited an unwillingness to fully exercise this power. Sadly, the Eighth Circuit exhibited such reluctance in Grassmueck v. American Shorthorn Ass’n, which did not even note Alam’s argument and only considered the Tenth Circuit precedent in Sender. In Adelphia, the court considered Alam’s equitable argument but refused to apply it because it might not be consistent with Pennsylvania state law. Practically, the proposed federal common law rule would provide the same equitable effects because it is upon the equitable principal that the wrongdoers should not benefit from their own wrongdoing if they are equally as culpable or more than the defendant. However, the proposed rule would force bankruptcy courts to consider the equitable principles noted by Alam.

According to Davis, the in pari delicto doctrine should be generally
ignored unless “the debtor’s conduct through its managers has a substantive impact on the debtor’s cause of action, such as defeating an element of the prima facie case or by creating a substantive affirmative defense.”

Davis’s article relies upon the Congressional Report noting that Section 541(a)(1) clearly states, the estate is comprised of all legal and equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate except to the extent that defenses which are personal against the debtor are not effective against the estate.”

The leading treatise relies upon this congressional report as well. Davis’ article controversially argued that the property of the bankruptcy estate is a matter of federal law. Davis provided examples of United States Supreme Court precedent supporting his position. However, the Supreme Court has more explicitly backed the contrary proposition that state law controls the analysis of property interests unless explicitly preempted by the Bankruptcy Code. The other major shortcoming of Davis’s article is the complete bar of in pari delicto against innocent successors. If the wrongdoers remain employed by the debtor, or are creditors of the estate, they may receive a windfall that they would not receive outside of bankruptcy. One partial solution is subrogation of the wrongdoer’s claims. However, equitable subordination is rarely used and it does not deal with the issue of the wrongdoers’ continued employment with the debtor.

Catherine Vance’s recent article and blog provide excellent insight into problems of the in pari delicto doctrine but they also stray from the most important issue, the distinction between the trustee and the wrongdoers. Her argument correctly notes that imputation of fault should not equal a bar to recovery under in pari delicto but instead should only be the first step of the inquiry. The in pari delicto analysis should only occur after the court determines that the wrongdoer’s actions were imputed. Courts frequently ignore the second step and find the first step sufficient to bar an innocent successor’s claims. Vance also argues that in pari delicto
should not be used to displace traditional tort defenses.\textsuperscript{153} She posits that \textit{in pari delicto} is irreconcilable with modern comparative negligence doctrine and instead, the plaintiff’s fault should reduce damages after a finding of legal and proximate cause.\textsuperscript{154} Changes in state law would be slow but they could be accelerated by certified questions.

The Pennsylvania Supreme Court’s recent answer to the Third Circuit’s questions regarding \textit{in pari delicto} provides an illustration of the inherent problems of certified questions. The Pennsylvania Supreme Court noted that certified questions were an “unusual practice through which, for the sake of comity, we undertake to address legal issues outside the familiar setting of a case over which we have conventional jurisdiction.”\textsuperscript{155} Hence, the court stated it would only address the issues narrowly within the scope of the questions and leave other issues, such as the validity of the cause of action for aiding and abetting a breach of fiduciary duty and the innocent decision-maker exception to \textit{in pari delicto}, unanswered.\textsuperscript{156} Considering the reluctance and narrowness of the Pennsylvania Supreme Court’s opinion, the process of changing the rules for \textit{in pari delicto}, state by state, would take a long time even accounting for the prodding of certified questions. Changes would provide clarity and guide correct application of the \textit{in pari delicto} both in state and federal court. However, even if \textit{in pari delicto} is incompatible with state law, it provides an invaluable screening device particular to bankruptcy and therefore should be enshrined as a federal common law rule.\textsuperscript{157}

Each of these arguments possesses merit and each plays some part in this article’s proposed federal common law rule. But why do we need a federal common law imputation rule at all?

**NECESSITY OF A FEDERAL COMMON LAW RULE**

A federal common law rule is necessary to help solve the significant conflict between bankruptcy law and state law over \textit{in pari delicto} application. Here, this article considers the standard for creating a federal common law rule. Although the standard is high, it is not insurmountable. \textit{In pari delicto} creates a larger conflict between state law and federal policy than imputation, thereby distinguishing it from \textit{O’Melveny & Myers v.}
Federal Deposit Ins. Corp. The policies include greater judicial economy as well as uniform equity.

This portion of the article then profiles the symptoms flowing from lack of uniform equity including questionable judicial maneuvers to halt inequity and the extreme uncertainty stemming from unsettled state law. Following the Supreme Court’s emphasis on uniformity in Cent. Va. Cmty. College v. Katz, creating a federal common law rule for in pari delicto is now easier, at least according to one commentator. A federal common law rule would make federal judges’ attempts to alleviate the inequity of applying in pari delicto to innocent successors unnecessary. Even though scholars and judges exposed the innocent decision-maker exception as a product of judicial error, its continued use illustrates the depths of the conflict. State judges may follow the model of New Jersey and create exceptions to in pari delicto for certain professionals. Such exceptions can create inverse inequities from the majority circuit approach because wrongdoers may still benefit as creditors or employees, even if their imputed culpability is greater than the defendant’s. Lastly, unsettled state law creates uncertainty that can stall litigation, a disastrous consequence for Chapter 11 proceedings in particular.

The Standard for Federal Common Law Rules in Bankruptcy

Clearfield Trust Company v. United States paved the way for a federal common law rule guiding the application of in pari delicto to innocent successors. In the Clearfield, the Supreme Court held that federal courts could apply federal common law to government-issued commercial paper. Therefore, the Erie Doctrine does not require federal courts to always apply state law. However, in Butner v. United States, the Supreme Court held that “[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently [than state law] simply because the interested party is involved in a bankruptcy proceeding.” The Butner policy exception is an onerous standard that limits bankruptcy courts’ creation of federal common law. However, the application of in pari delicto to innocent successors exceeds the standard.

The Supreme Court’s decision in O’Melveny & Myers governs the application of state law imputation doctrine to federal statutes. However,
the direct relationship between imputation and *in pari delicto* profiled above makes concerns about the latter applicable to the former. In *O’Melveny & Myers*, the Federal Deposit Insurance Corporation (“FDIC”), acted as the receiver for American Diversified Savings Bank, a failed federally insured savings and loan association.¹⁶⁴ The FDIC charged the debtor’s law firm who represented the debtor’s disastrous real estate transactions with breaches of fiduciary duties and professional negligence.¹⁶⁵ The Ninth Circuit used a federal common law rule to preclude imputation of the wrongdoers’ bad actions to the FDIC due to conflict between California state law and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”).¹⁶⁶ The Supreme Court refused to “adopt a court-made rule to supplement federal statutory regulation that is comprehensive and detailed; matters left unaddressed in such a scheme are presumably left subject to disposition provided by state law.”¹⁶⁷ The F.D.I.C.’s need for a uniform law in its nationwide litigation of similar suits was insufficient grounds for a federal common law rule.¹⁶⁸ Additionally, the depletion of the insurance fund created insufficient conflict because “more money arguments,” predicated upon enriching the federal government, have historically failed as grounds for federal common law rules.¹⁶⁹ Instead of foreclosing a federal rule for imputation, the Court explained the necessity of a “significant conflict between some federal policy or interest and the use of the state law.”¹⁷⁰

The application of *in pari delicto* to innocent successors presents a much larger conflict and involves stronger federal policies than the conflict profiled in *O’Melveny & Myers*. First, the proposed common law rule creates greater judicial economy. Creditors are a unified body in bankruptcy as the Bankruptcy Code forces them to work together for the maximization of the estate instead of individual gains.¹⁷¹ If the wrongdoers will not benefit, then there is no justification for herding creditors into unnecessary separate proceedings where the creditors would lose any lose priority in bankruptcy.¹⁷² However, uniformity provides far stronger support for a federal common law rule of *in pari delicto*.

**Importance of Uniform Equity**

Although uniformity was an insufficient basis for a federal common law rule in *O’Melveny & Myers*, the Supreme Court may have signaled
that the path towards federal common law rules in bankruptcy is easier than it was prior. The judicial reaction to inequitable results for creditors aids the case for a federal interest in uniformity. If the conflict were not strong, then why have courts at both state and federal level responded to the inequity? The judicially-created exceptions are legally questionable end-runs around *in pari delicto*. The innocent decision-maker exception perverts agency law and limits the monitoring incentive created by imputation. The auditor exception of the New Jersey Supreme Court, and now the Third Circuit, creates an exception to *in pari delicto* for auditors so they cannot use the doctrine, even when it will reward wrongdoing plaintiffs with higher levels of culpability. *In pari delicto* is so unsettled in some states that a federal common law would save valuable time and increase the chances of settlement aiding and abetting claims.

The Supreme Court’s decision in *Central Virginia Community College v. Katz* may provide further ammunition by bolstering the importance of uniform bankruptcy law. The Court’s historical analysis centered on two cases contemporaneous with the signing of the Constitution, *Millar v. Hall* and *James v. Allen*. Both cases involved a debtor who gave all his property to a creditor in return for a discharge in one state but became imprisoned in another state for inability to pay his debts. The debtors in both cases argued that their “earlier discharge should be given preclusive effect.” On its face, it may seem that the Framers enacted the Bankruptcy Clause, to protect debtors but it also aids creditors because a rational debtor would never agree to a discharge without guarantees from all inter and intrastate creditors. This protection is reflected by *Katz’s* holding that “Congress has the power to enact bankruptcy laws the purpose and effect of which are to ensure uniformity in treatment of state and private creditors.” According to Richard J. Haines, this benefit to creditors was what “the Framers intended when they authorized Congress to establish uniform law on the subject of bankruptcies throughout the United States.” *Katz’s* holding may be narrow and fail to implicate federal common law because the case dealt primarily with abrogation of sovereign immunity against avoidance of preferential transfers. However, the Supreme Court’s focus on uniformity in the Framer’s era could signal that the standards of *Butner* are lower than previously thought. Hence,
Katz may signal that a federal common law rule of *in pari delicto* is more attainable.\textsuperscript{184}

**Innocent Decision-Maker Exception**

The innocent decision-maker exception is a perversion of imputation law sustained only to mitigate harsh application of the *in pari delicto* defense to innocent successors.\textsuperscript{185} The origin of the innocent decision-maker doctrine stems from an *in pari delicto* case, *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld LLP*, where the bankruptcy trustee pursued claims of legal malpractice against the firm who represented the debtor corporation.\textsuperscript{186} The debtor operated as a Ponzi scheme under the direction of its officers.\textsuperscript{187} The district court’s opinion incorporated the magistrate judge’s report which noted that courts can negate imputation of the wrongdoers’ actions to the corporation, and the succeeding innocent trustee, if at least one of the corporation’s agents did not participate in the wrongdoing and could have stopped it.\textsuperscript{188} Jonathan Witmer-Rich and Mark Herrmann’s article exposed this doctrine as an analytical mistake.\textsuperscript{189} Under the sole actor rule, wrongdoing is always imputed to a sole shareholder-director because the principal and the agent are a single entity.\textsuperscript{190} Hence, the adverse interest exception does not apply.\textsuperscript{191} However, *Wechsler’s* attempted corollary does not comport with agency law.\textsuperscript{192} The adverse interest exception limits imputation because it negates an element, the principal’s benefit.\textsuperscript{193} In contrast, the independent decision-maker exception does not implicate any element of imputation and lacks support in traditional agency law.\textsuperscript{194}

Witmer-Rich and Herrmann note that the innocent decision-maker exception’s popularity derives from an “underlying desire on the part of courts to permit corporate complicity claims.”\textsuperscript{195} This “underlying desire” is motivated by courts’ belief that application of *in pari delicto* to innocent successors is inequitable.\textsuperscript{196} However, the innocent decision-maker doctrine has little actual value because it does not help ensure that wrongdoers will not benefit from the innocent successor’s recovery.\textsuperscript{197} Hence, this bastard doctrine is only kept alive in an effort to mitigate the harshness of the application of *in pari delicto*. Thankfully, this mistaken doctrine was identified before bureaucratic inertia took over. However, its existence il-
lustrates the substantial conflict between the application of *in pari delicto* and federal bankruptcy policy.

**The Auditor Exception**

Bankruptcy courts are not alone in trying to stem the tide against innocent successors. The New Jersey Supreme Court’s Auditor Exception produces lower standards of liability for applicable third party aiders and abettors. Hence, the Auditor Exception flips the conflict from usual issue of an inequitable bar to innocent successors. Instead, it can create inequitable outcomes where the wrongdoing plaintiff, who would be equitably barred but for the exception, benefits from the successor’s recovery.

The exception to *in pari delicto* in New Jersey imputation law illustrates that state law can go beyond balancing the equities. In *NCP Litigation Trust v. KPMG LLP* (“*NCP*”), two of the debtor’s officers inflated the debtor’s revenues through fraudulent transactions. The two officers misrepresented the transactions to their auditor, KPMG. The wrongdoers were KPMG’s only conduit of financial information. Although KPMG failed to originally detect these misrepresentations, it eventually discovered the wrongdoing and exposed the guilty wrongdoers. In *NCP*, the court did not allow the defense of *in pari delicto* against the litigation trust, an innocent successor, because “allowing KPMG to avoid liability for its allegedly negligent conduct would not promote the purpose of the imputation doctrine—to protect the innocent.” This holding created an exception to *in pari delicto* and closed the defense to auditors.

The holding of the *NCP* court goes further than simply balancing the equities between the innocent successor and the third party. The court noted that other courts consider the beneficiaries when deciding whether to bar an innocent successor’s claim. In *pari delicto* might equitably bar the innocent successor’s claim if the wrongdoers were beneficiaries of the litigation trust and their bad deeds were more culpable than the aider and abettors. However, under the *NCP* auditor exception, the auditor’s “culpability, if established, would estop it from raising a defense of imputation (and *in pari delicto*).” Hence, even if the auditors were only negligent and the insider beneficiaries were intentional wrongdoers, the auditors could not use *in pari delicto*. The *NCP* court possessed a
chance to create a general exception to in pari delicto when the wrongdoers are removed from the scene. Instead, the court created a possibly inequitable exception to in pari delicto.

In Thabault v. Chait, the Third Circuit applied the auditor exception in an analogous situation to NCP. In Thabault, an insurance company filed for bankruptcy as a result of its officers’ concealment of the company’s losses through multiple misrepresentations. The receiver for the trust alleged that PriceWaterhouseCoopers (“PwC”), then Coopers, negligently conducted two of its audits leading to the insurance company’s bankruptcy. The court applied the “auditor negligence exception” noted in NCP because “PwC was not a victim of [the debtor’s] fraud and allowing it to avoid liability by invoking the in pari delicto doctrine would not serve the purpose of the doctrine-to protect the innocent.” However, if the wrongdoers benefit from the recovery, the guilty are rewarded along with the innocent.

When the wrongdoers have few claims, this course may be equitable if other forms of litigation create significant hardship. However, a blanket exception may force a court applying NCP or Thabault to allow the innocent successor’s claim even when the wrongdoers are the principal beneficiaries.

Unsettled Law

The Third Circuit exhibits the good, the bad, and the ugly versions of in pari delicto analysis. Starting with the good (the equitable), In re Jack Greenburg, a number of the debtor’s officers breached their fiduciary duties by falsifying inventory statements and other information leading to an overstatement of the debtor’s income. The debtor’s auditor examined every invoice and failed to detect the manipulations which eventually lead to the corporation’s bankruptcy. The trustee brought charges of aiding and abetting breaches of fiduciary duty against the auditor. Because of a lack of Pennsylvania in pari delicto precedent, the Eastern District of Pennsylvania predicted how the Pennsylvania Supreme Court would apply in pari delicto. The court concluded that in pari delicto would not be applied to produce an inequitable result under Pennsylvania law. Therefore, the court did not apply in pari delicto to the trustee because the
wrongdoers would not benefit from the innocent trustee’s recovery. 222

The bad (or inequitable) is shown in *Lafferty* 223 where the Third Circuit discussed neither *Jack Greenberg* nor the precedent it relied upon. 224 Granted, these cases are not binding precedent but the court should at least have considered their rationales.

*Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PriceWaterhouseCoopers, LLP* represents the ugly by possibly starting a trend toward unwieldy certification of *in pari delicto* questions to state courts. There, the Foundation’s officers knowingly misstated the Foundation’s finances because they were unwilling to admit their integrated-delivery-system model failed to produce net income. 225 The Foundation used PwC to audit its financial statements and during the years of the misstatements and PwC subsequently provided a “clean” opinion indicating the accuracy of the Foundation’s financial statements. 226 The Foundation’s board, comprised of both the wrongdoers and innocent members, relied upon the audit and continued the strategy until the Foundation’s bankruptcy. 227 The Official Creditors’ Committee brought charges of aiding and abetting against PwC. 228

Instead of relying upon previously settled predictions of state law, the Third Circuit certified the question to the Pennsylvania Supreme Court. 229 Instead of relying on *Jack Greenberg* or *Lafferty*, the court “believe[d] the appeal raise[d] important and unresolved questions concerning the interaction between the *in pari delicto* doctrine and the imputation of an agent’s fraud to his principal under Pennsylvania law.” 230 Debating the merits of certification is beyond the scope of this article. Even though certification “permits litigants to short-circuit the ordinary state-court hierarchy by going directly to the state high court[,]” 231 the court must still answer the question. Over a year and half later, the Pennsylvania Supreme Court finally answered. 232

A federal common law rule for applying *in pari delicto* to innocent successors would make such questions and the delay associated with their answer unnecessary. The Third Circuit is not alone in looking for aid from a state’s court of last resort as the Second Circuit has now followed its lead and certified questions about New York application of *in pari delicto*. 233 However, the delays associated with this trend may harm any prospects
for reorganization. Speed is vital for the success of a Chapter 11 plan and if the innocent successor can make a significant recovery in less time, it could significantly aid the debtor’s recovery.\textsuperscript{234} Additionally, certified answers are often answered narrowly, thereby leaving vital questions unresolved.\textsuperscript{235}

**PROPOSED FEDERAL COMMON LAW RULE**

This portion of the article describes the proposed federal common law rule as well as its possible limitations. First, it considers the possibility that wrongdoers can remain employed at the debtor, or are creditors of the debtor. If the wrongdoers are neither employed by the debtor,\textsuperscript{236} nor its creditors, then the court should not apply \textit{in pari delicto} to the innocent successor. This rule comports with Supreme Court precedent applying \textit{in pari delicto}. However, if the wrongdoers are creditors or remain employed by the debtor, then the court should apply the \textit{in pari delicto} framework used by the Supreme Court. Then, it considers the possibility of bankruptcy courts applying the framework inequitably or incorrectly. Without actual examples of the proposed federal common law, the most similar example is the \textit{in pari delicto} framework used in RICO cases. The RICO cases illustrate the importance of the first step prior to the usual \textit{in pari delicto} analysis because without identifying wrongdoing beneficiaries, inequitable results will continue.

**Federal Common Law Framework**

The court must first ascertain if the wrongdoers will benefit, as creditors or employees, from an innocent successor’s claim for aiding and abetting. Creditors are the primary beneficiaries of the estate, and the innocent successor represents their interests.\textsuperscript{237} All bankrupt entities must file a schedule of creditors which will allow the court to discern if any of the wrongdoers are creditors.\textsuperscript{238} However, employees of the debtor may also benefit. A successful aiding and abetting claim may significantly enlarge the estate, the subsequent payouts to creditors, and the prospects for a successful reorganization.\textsuperscript{239} The future employment prospects of the debtor’s current employees, irrespective of wrongdoing, are directly proportional
to the chances for successful reorganization. The continued employment of wrongdoers who would benefit from the aiding and abetting claims seems almost unimaginable but that is not the case in many Chapter 11 cases. The debtor’s officers and management know the business better than anyone else and therefore, can presumably run it more efficiently. Hence, courts and creditors are often wary of replacing management, even when they were the primary wrongdoers. To identify wrongdoers employed by the debtor, the court should cross-reference the debtor’s list of current management and directors with a list of the wrongdoers.

The application of in pari delicto to federal statutes depends upon two factors, whether “(i) the plaintiff, as compared to the defendant, bears at least substantially equal responsibility for the wrong he seeks to redress and (ii) preclusion of the suit would not interfere with the purposes of underlying law or otherwise contravene the public interest.” Both of these prongs must favor the defendant in order to bar a plaintiff’s recovery using in pari delicto.

Two Supreme Court cases, Bateman Eichler, Hill Richards, Inc. v. Berner and Perma Life Mufflers, Inc. v. Int’l Parts Corp., illustrate the application of the federal in pari delicto doctrine. In Bateman Eichler, tippees received inside information, sustained losses, and sued the tippers. The Court ruled that the tippees were only derivative violators of security regulations and compared to the tippers, they were not of equal or greater fault. The Court also considered the relative efficacy of deterrence for tippers compared to tippees. The tippers, as the more sophisticated party, were more likely to be advised by counsel and therefore, would be better deterred by liability. Because neither prong favored the defendants, the plaintiffs were not barred by in pari delicto. The Court also noted that in pari delicto’s public interest prong is grounded upon the specific goals of the applicable federal statute as well as two additional premises: “first that courts should not lend their good offices to mediating disputes amongst wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.” In Perma Life Mufflers, franchisees alleged anti-trust violations against their franchisor. The franchisor countered that the franchisees who entered into the franchise agreement were equally culpable in the violations.
Court ruled that the franchisees were not barred by \textit{in pari delicto} because they were passive violators who did not seek out the terms that breached antitrust law and their wrongdoing “was not voluntary in any meaningful sense.” The proposed federal common law rule comports with this framework. The first step is deciding whether the wrongdoers will benefit from the innocent successor’s recovery. If the wrongdoers are completely removed, barring the plaintiff’s claims is unnecessary because the wrongdoers will not benefit.\textsuperscript{255} The true beneficiaries of the innocent successor’s claims for aiding and abetting should not be penalized if the wrongdoers will no longer benefit, no matter when they were dismissed.\textsuperscript{256} Then, if the wrongdoers will benefit because they are creditors or remain employed by the debtor, a federal \textit{in pari delicto} analysis should be used. Comporting with the federal \textit{in pari delicto} analysis, the proposed rule uses the same two prongs, the comparison of culpability and the public interest. Both prongs must favor the defendant in order to bar the plaintiff’s action for aiding and abetting suit.

A comparison of two Seventh Circuit receivership cases, \textit{Scholes v. Lehman}\textsuperscript{257} and \textit{Knauer v. Jonathon Roberts Financial Group},\textsuperscript{258} provides an apt illustration why the federal rule should first consider the beneficiaries of the innocent successor’s claims. In \textit{Scholes}, the Seventh Circuit imputed a wrongdoer’s breach of fiduciary duty stemming from the operation of a Ponzi scheme to the debtor corporations.\textsuperscript{259} However, after a court appointed a receiver, the wrongdoer no longer controlled the debtors\textsuperscript{260} and the creditors were victims of the Ponzi scheme, not its perpetrators.\textsuperscript{261} Because the wrongdoers were completely removed, the Seventh Circuit did not bar the receiver’s claims using \textit{in pari delicto}.\textsuperscript{262} Following the same analytic process, the Seventh Circuit in \textit{Knauer} distinguished \textit{Scholes} because the creditors included wrongdoers.\textsuperscript{263}

If the case before us involved the voiding of a fraudulent conveyance, as in \textit{Scholes} or the Indiana cases just cited, we would likely apply \textit{Scholes} and the Indiana law favoring exceptional treatment of receivers in those circumstances. This case, however, presents a different equitable alignment. The key difference, for purposes of equity, between fraudulent conveyance cases such as \textit{Scholes} and the instant case is the identities
of the plaintiffs. The receiver here is not seeking to recover the diverted funds from the beneficiaries of the diversions (e.g., the recipients of Douglas’s transfers in Scholes). Rather, this is a claim for tort damages from entities that derived no benefit from the embezzlements, but that were allegedly partly to blame for their occurrence.

The Seventh Circuit again first considered whether the wrongdoers remained employed by the debtor or were creditors. Then, after deciding that they were creditors, the court did not apply Indiana law because it would create an inequitable result. Under a federal common law rule, this choice of law manipulation would not be necessary, and the court could simply use the federal framework for *in pari delicto*.

If the wrongdoers either remain employed by the debtor or are creditors, then the court should use the federal *in pari delicto* framework. *In pari delicto* should only bar an innocent successor if both the first factor and the second factor favor the defendant. When considering the first prong, the relative culpability of the parties, a court should be mindful of the key considerations of the Supreme Court: whether the plaintiff’s liability was a result of the defendant’s wrongdoing and the voluntariness of the plaintiff compared to the defendant. Commentators and judges have roundly criticized courts allowing alleged aiders and abettors to escape liability when the plaintiff was negligent while the defendant was at least recklessly culpable. A comparison of culpability will not bar an innocent successor’s action in this situation because the defendant’s negligence is less voluntary than the plaintiff’s conduct.

The culpability comparison is complex because the court must consider artificial entities and differing standards of scienter. When comparing the fault of the innocent successor with an aider and abettor’s, on the one hand “aiding and abetting requires proof of scienter. [Therefore,] [p]ersons committing the tort are fully aware that they are acting against the corporation.” On the other hand, imputation, which results from the relationship between the principal and agent, not the principal’s scienter, makes the principal vicariously liable for its agent’s actions. In fact, imputation treats a principal as knowing and conducting the actions of agents even when the agent does not disclose the facts or actions to the principal. Furthermore,
a principal’s liability can even include its agent’s actions when they do not comport with the principal’s directions or wishes. Therefore, it can be difficult to judge the culpability of a corporation imputed with wrongdoers’ faults. Courts must consider the ability of an artificial entity to police not only fraudulent intent but also negligent behavior. Even though the fiction of corporate personality requires imputation,

the defendant is an artificial body, acting only as moved by its trustees or corporators and stockholders, having no will or capacity to act except through their action and instrumentality; and, although it is liable for all the legal consequences of its transactions, done under their direction and authority, it appears to be a perversion of every rule and principle in determining the relative culpability or fault of parties, to say that a corporation thus acting and impelled to such action is more culpable than a living, intelligent trustee, who was a party moving and active in causing the action to be had.

It is difficult to consider the actions of a corporation voluntary, let alone knowing and sufficient to constitute scienter, the required level of culpability for aiding and abetting. Hence it may seem that the corporation would never have a higher culpability; however, the defendant can often use the same excuse. Innocent successors rarely sue individuals and instead target partnerships and corporations as the alleged aiders and abettors. Courts must consider that imputation and scienter can be double-edged swords.

The second prong, the public policy prong, is also necessary, but not sufficient to invoke *in pari delicto*. Allowing the innocent successor to bring a suit for aiding and abetting a breach of fiduciary duty furthers the goals of the Bankruptcy Code. The goal of Chapter 7 is the maximization of the value of the estate while Chapter 11 adds the goal of rehabilitating the debtor. Restricting the ability of an innocent successor to pursue claims for aiding and abetting decreases the potential size of the estate because aiders and abettors are joint and severally liable with principal tortfeasors. Hence, but for a bar of *in pari delicto*, the innocent successor can pursue a deep pocketed aider and abettor as well as the wrongdoers. The public policy prong of *in pari delicto* also considers the Supreme
Court’s twin aims of stopping judicial mediation of wrongdoers and deter-
ring illegality by denying a wrongdoer judicial relief. Courts should not
waste judicial resources on disputes between equally culpable wrongdo-
ers. Hence, the greater the amount of wrongdoer claims, or number
of wrongdoing employees, the more the case becomes a dispute amongst
wrongdoers. Analyzing the efficiency of using *in pari delicto* to deter
wrongdoing is difficult because, again, a court must consider the ability of
corporations to control their agents and the harshness of imputation. The
proposed federal common law rule is diagramed below.

**Proposed Federal Common Law Rule for Application of *In Pari Delicto* to Innocent Successors**

1: Are the wrongdoers creditors or employees of the debtor?

- Yes
- No

2. Federal *In Pari Delicto* Analysis

   Comparative Culpability
   Public Policy

   If both favor defendant then
   *in pari delicto* properly bars
   the innocent successor’s claims

**Comparative Application of *In Pari Delicto* in RICO**

The application of the federal law framework is not foolproof. In
factually analogous cases applying the federal law framework of in pari
delicto to a trustee’s RICO claims, the Eleventh Circuit and the Eastern District of Pennsylvania came to opposite results. Some courts still find ways to resist logic and snatch injustice from the jaws of equity.

The Eleventh Circuit in *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards* used a similar framework to the proposed rule but still came to an inequitable result because it did not consider the true beneficiaries. There, ETS, operated a Ponzi scheme predicated on the sale and leaseback of payphones as investment opportunities. IRA Custodians, holders of large retirement accounts, allegedly aided ETS by investing in the Ponzi scheme without conducting due diligence and ignoring evidence of the scheme. The trustee claimed treble damages against IRA for its role in the RICO violations.

Evaluating the first prong of the *in pari delicto* framework, comparison of fault, the court found that ETS was at least as responsible for the RICO violations as the IRA, and therefore, the succeeding trustee was equally culpable. Thus, the first prong favored barring the trustee’s allegations.

Evaluating the second prong, the policy goals of the federal statute, the court noted that the goal of RICO is “eradicat[ing] organized crime from the social fabric by divesting an association of the fruits of ill-gotten gains.” The court found that recovery by the trustee against IRA would only “result in a wealth transfer among similarly situated conspirators.” The court bulwarked this assertion by noting that “a federal RICO violation requires affirmative and deliberate participation.” Because both ETS and IRA were “similarly situated” as part of the conspiracy, the court distinguished the case from others where the plaintiffs only “passively acquiesced” to the wrongdoing.

In re Jamuna Real Estate, LLC, the Eastern District of Pennsylvania used the same analytical framework as the Eleventh Circuit but achieved an equitable result partially because the court considered the true beneficiaries. The case involved RICO and RICO conspiracy claims against the Bagga and Chawla families who converted the proceeds from secured loans made to the debtor corporations that they controlled. The defendants tried to invoke *in pari delicto* to bar the trustee’s claim because he stood in the shoes of the debtor. The court followed the same framework as *Edwards* and first compared culpability of the parties. Although the debtor received loans and contributed to the scheme, the defendants
controlled the debtor and were the scheme’s primary beneficiaries because they siphoned off the proceeds of the loan funds into other corporations they controlled or converted them for their own use. Therefore, the defendants were the more culpable party because “[t]he claim that the Debtor, and thereby the Trustees, were active participants in the RICO violations is not supported by what is alleged.”

Next, the court decided that using in pari delicto to bar trustee RICO claims in this case would undercut RICO and public policy. Unlike Edwards, the court found that a successful RICO claim would not shift assets from one conspirator to another. Instead of simply focusing on the debtor and its wrongdoing, the court discerned the identities of the creditors who were the beneficiaries of the trustee’s actions. Neither of the debtor corporations had secured claims, while their receivables vendor held the vast majority of the unsecured debt. Furthermore, the court noted that the trustee could file to disallow the claims of creditors complicit in the wrongdoing. Hence, the second prong favored the trustee as well.

Edwards and Jamuna illustrate possible pitfalls for the proposed common law rule. Focusing on the second prong, both courts considered whether the wrongdoers were creditors, and both cases were Chapter 7 liquidations without the risk of the wrongdoers’ continued employment. However, Jamuna considered the identities of the actual beneficiaries. Edwards only considered the corporation as the beneficiary, and in a Chapter 7, the liquidated corporation’s creditors, not the dying corporation, are the beneficiaries. The law should focus on those who will benefit if it wishes to restrict wrongdoers from receiving the bounty of their wrongdoing. Hence, the first step of the proposed common law rule, the identification of wrongdoing beneficiaries would forestall an inequitable result like Edwards.

LEHMAN BROTHERS

This portion of the article profiles the Lehman Brothers bankruptcy and the adversarial proceeding against Barclays for allegedly aiding and abetting breaches of fiduciary duty by Lehman executives. The case appears headed toward an in pari delicto showdown. This high profile case, if appealed, will give the Second Circuit a chance to exorcize the Wagoner
rule and create a new federal common law rule.

The looming bankruptcy of a firm often ripens opportunities for breaches of fiduciary duty by employees looking to profitably extricate themselves from the sinking ship. The bankruptcy of Lehman Brothers allegedly involved such self dealing.\textsuperscript{305} On November 16, 2009, Lehman Brothers Holdings, the debtor-in-possession for the Chapter 11 bankruptcy case of Lehman Brothers, filed a complaint, against Barclays for aiding and abetting the breaches of fiduciary duty by Lehman Brothers employees.\textsuperscript{306} The complaint alleged that Lehman Brothers executives agreed to give Barclays a $5 billion discount from the book value of the assets it purchased from Lehman Brothers.\textsuperscript{307} Furthermore, they even allegedly modified the proposed transaction dramatically in Barclays’ favor.\textsuperscript{308} The Lehman executives still owed fiduciary duties, specifically a duty of loyalty, to Lehman Brothers.\textsuperscript{309} The excellent deal Barclays received was not free. Barclays allegedly aided and abetted these alleged breaches of fiduciary duty by offering lucrative employment arrangements to Lehman Brothers executives to “induce them to agree to sell…Lehman assets for a lower-than-warranted price.”\textsuperscript{310}

The high profile case of \textit{In re Lehman Brother Holdings Inc.} provides the perfect platform for the creation of a federal common law rule for the application of \textit{in pari delicto} to innocent successors. First, the Southern District of New York Bankruptcy Court will consider whether to impute the breach of fiduciary duty by Lehman insiders to Lehman Brothers. However, the analysis is altered because Lehman was insolvent so the fiduciary duties of a corporation switch from the shareholders to the creditors.\textsuperscript{311} The allegations of the complaint make the chances of imputation seem remote because imputation requires that the principal benefit from its agents’ actions. Discounted sales of corporate assets indirectly loot a corporation, a breach that does not provide any benefit to the corporation.\textsuperscript{312} Additionally, true self dealing transactions would provide neither Lehman nor its creditors with any benefit. However, the threshold for the minimum amount of benefit necessary for imputation is both low and unsettled.\textsuperscript{313} Barclays’ answer alleges that the deal was a boon for Lehman’s creditors. Supposedly, if deal had not closed, the creditors would have lost millions because Lehman’s assets were deteriorating rapidly.\textsuperscript{314} Barclays
also alleges that its status as the only bidder provided sufficient leverage to get the discount it received.\textsuperscript{315} If Lehman’s creditors benefited from the transaction, Lehman could be imputed with the wrongdoers’ actions. Imputation would also require that the wrongdoers were acting within their capacities as agents for Lehman. If the Lehman Brother executives’ actions are imputed, Barclays will undoubtedly try to bar the holding company’s suit using \textit{in pari delicto}.

The New York Court of Appeals has accepted certified questions regarding \textit{in pari delicto} which may impact the proceeding but they are based mostly upon the adverse interest exception.\textsuperscript{316} Therefore, unless an exception applies, the Southern District of New York will follow precedent and apply the \textit{Wagoner} rule\textsuperscript{317} or \textit{in pari delicto}, to bar the holding company’s aiding and abetting claims against Barclays.

Under a federal common law rule, the court would follow same first two steps of deciding who breached their fiduciary duties and if it could be imputed to the firm. The inquiry then diverges as the court would next crosscheck the list of wrongdoers with those still working for the holding company.\textsuperscript{318} Subsequently, the court would compare the list of wrongdoers to the schedule of creditors to see if any of the aforementioned individuals, or entities they controlled, were creditors. If the judge answered both of these questions negatively, then \textit{in pari delicto} would not be applied to the holding company. If the judge answered either question affirmatively, the judge would apply the remaining two prongs. The first prong compares the fault of the plaintiff and the defendant. Here, both parties were active participants in the breach but one factor noted by the Supreme Court could favor Lehman. Barclays’ leverage as the only bidder may have forced the insiders to consummate a deal. This asymmetric bargaining is analogous to the power of the franchisor over franchisees in \textit{Permalife}. However, the increased leverage would not explain the employment contracts for the wrongdoers.

The second prong of the inquiry would only be necessary if the defendant prevailed on the first prong. Under the second prong, the court would consider whether a restriction of the plaintiff’s claim will undercut the policy objectives of the Bankruptcy Code. The judicial system has a strong interest in deterring discounted sales in return for personal benefits. The
court should also consider that the creditors to whom the breached fiduciary duty was owed would be the eventual beneficiaries of any recovery. Another factor possibly favoring the plaintiff is the difficulty of deterring insider transactions, especially when decisions are made very quickly with little accountability. The sale of the assets by Lehman is exactly such a situation. Therefore, restricting Lehman’s action would not have strong deterrent effects upon other wrongdoers.

CONCLUSION

Lehman Brothers is only the tip of the iceberg. As the dust settles on this recession, more innocent successors will bring claims of aiding and abetting breaches of fiduciary duty against third parties. How will courts handle these claims? The need for a federal common law rule is based on equitable necessity not current convenience. The standard for creating a common law rule is high but the conflict between state law and federal polices is stark. State courts may change their in pari delicto regimes but such changes may not make them equitable for application in bankruptcy. In pari delicto’s popularity has increased dramatically in the last 15 years. Its popularity sadly stems from its current inequitable application. The focus needs to return to denying wrongdoers the fruits of their wrongdoing. The proposed federal common law rule restores that focus and would help create more equitable results.

NOTES

2 Id.
3 Id.
4 Sender v. Buchanan (In re Hedged-Invs. Assocs.), 84 F.3d 1281, 1285 (10th Cir. 1996).
5 Id.
6 The First, Second, Third, Fourth, Sixth, Eighth, Tenth, Eleventh and DC circuits have all upheld the use of in pari delicto to bar trustee claims. See

7 See infra discussing imputation.
9 See infra discussing the Wagoner Rule.
10 For the sake of brevity throughout the article when the phrase “application of in pari delicto to innocent successors” is used, it refers to aiding and abetting fiduciary duty claims not other claims such as fraudulent transfers or RICO where in pari delicto is also used.
13 See infra note 138 and accompanying text.
15 See Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006); Alberts v. Tuft (In re Greater Southeast Cmty


17 See infra notes 184-197 and accompanying text.


21 Risa L. Wolf-Smith, Innocent Trustee/Creditors Barred by Debtors’ Past Wrongs: It Just Ain’t Right, 26 AMER. BANKR. INST. J. 42, 43 (2007).

22 Sender v. Buchanan (In re Hedged-Ins. Assocs), 84 F.3d 1281, 1285 (10th Cir. 1996).

23 See infra discussing the innocent decision-maker exception.

24 See infra discussing the auditor exception.


27 See Mediators, Inc. v. Maney (In re The Mediators, Inc.), 105 F.3d 822, 826 (2d Cir. 1997) (“The Committee, while not a trustee in bankruptcy, is in a position analogous to a trustee because it is suing on behalf of the debtor.”).


F.3d 340, 345 (3d Cir. 2001) (citations omitted).


36 Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001). Although the Bankruptcy code does not expressly allow creditors’ committees to sue on behalf of the estate it is “nearly universally recognized” because the creditor’s committee is often less distracted by other matters and therefore better able to bring claims than the debtor in possession or the trustee. Adelphia Commc’ns. Corp. v. Bank of Am. N.A. (In re Adelphia Commc’ns. Corp.), 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005) (citations omitted).


38 See Restatement (Second) of Torts § 874 cmt.a (1979).

39 Id. (“[a] fiduciary relation exists between two persons when one of them is under a duty to act for or give advice for the benefit of another upon matters within the scope of the relation”); NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 899 (N.J. 2006) (Rivera-Soto, J., dissenting) (“Although variously defined, the scope of the auditor’s engagement — what the auditor is to do in an engagement as opposed to how it is to be done — is driven exclusively by the specific wishes of the client.”) (emphasis in text); Deborah A. Demott, Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences, 48 Ariz. L. Rev. 925, 933-34 (2006).

40 The Bankruptcy Code’s definition of an insider includes “(1) a director of the debtor (2) an officer of the debtor (3) a person in control of the debtor (4) a partnership in which the debtor is a general partner (5) a general partner of the debtor or (6) a relative of the general partner, director, officer or person in control of the debtor…an affiliate of the debtor…managing agent of the debtor” 11 U.S.C. §§ 101 (31)(B), (E), (F). However this definition is merely illustrative. Official Comm. of Unsecured Creditors v. Austin Fin. Servs. (In re KDI Holdings, Inc.), 277 B.R. 493, 511 (Bankr. S.D.N.Y. 1999) (citations omitted).
43 See Restatement (Second) of Torts § 874 (1979) (“one standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation”).
45 Smith v. Arthur Andersen LLP, 421 F.3d 989, 1005 (9th Cir. 2005) (“The ultimate question in determining whether a trustee has standing is whether the debtor corporation has been injured.’
46 Moratzka v. Morris (In re Senior Cottages of Am. LLC), 482 F.3d 997, 1002 (8th Cir. 2007).
1984)). See infra discussion of innocent decision-maker.


53 Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 51 (2006).

54 Lerner v. Fleet Bank, N.A., 459 F.3d 273, 295 (2d Cir. 2006). Professional often serve on boards as directors and they owe direct fiduciary duties to the organization while third parties who aid and abet breaches of fiduciary duty by directors and other insiders often do not owe fiduciary duties to the corporation.


56 See Restatement (Third) of Agency §§ 503 (“For purposes of determining a principal’s legal relations with a third party, notice of a fact that an agent knows or has reason to know is imputed to the principal if knowledge of the fact is material to the agent’s duties to the principal….”), 707(2) (2006).


60 Id.

61 Id.

62 See supra discussion of § 541.

(applying Michigan agency law).


66 Liquidation Comm’n of Banco Int’l, SA v. Renta, 530 F.3d 1339, 1354-55 (11th Cir. 2008).


68 Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 60 (2006). Unlike the innocent decision-maker exception the adverse interest exception is based upon a traditional exception to in pari delicto for situations where the party is oppressed or unduly influenced. See Catherine E. Vance, “In Pari Delicto, Reconsidered,” 28 Amer. Bankr. Inst. J. 40 (2009) (citing Thomas v. Richmond, 79 U.S. 349 (1870)).

69 Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 60 (2006). Hence, “wrongdoing is always imputed when the wrongdoer is the sole shareholder because ‘the principal and agent are one and the same, …the agent’s knowledge [is imputed] to the principal’” Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 68 (2006) (citing Mediators, Inc. v. Maney (In re The Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997)).


72 See, e.g., O’Halloran v. First Union Nat. Bank of Fla., 350 F.3d 1197,


75 See Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47 (2006); See infra.

76 See Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 81 (2006) (citing the Restatement (Third) of Agency’s recognition of the adverse interest exception but not innocent successor exception); See infra.


79 Sender v. Buchanan (In re Hedged-Invs. Assocs.), 84 F.3d 1281, 1285 (10th Cir. 1996) (“Congress intended the trustee to stand in the shoes of the debtor. and ‘take no greater rights than the debtor himself had.’”(citations omitted)).


82 Id.

83 Id.


85 See, e.g., 11 U.S.C. §§ 362, 544(a), 547(b), 548 (a)(1), 553 (a)(1-3). The automatic stay stops all efforts to individually collect from the debtor, forcing creditors to pursue their claims collectively. The strong-arm powers, setoff
restriction, and preference as well as fraudulent transfer avoidance provisions help ensure equity amongst similarly situated creditors. See Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 14 (Harvard University Press) (1986) (“The most obvious reason for a collective system of creditor collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to repay them.”).


88 ALAN N. RESNICK ET AL., 15 COLLIER ON BANKRUPTCY ¶507.02[1][a] (15th rev. ed. 2008).

89 See ALAN N. RESNICK ET AL., 15 COLLIER ON BANKRUPTCY ¶507.02[1][a] (15th rev. ed. 2008) (many of the priority claimants are weaker groups such as those requiring domestic support obligations).


91 Sender v. Buchanan (In re Hedged-Invs Assocs.), 84 F.3d 1281 (10th Cir. 1996).


93 Id.


95 Sender v. Buchanan (In re Hedged-Invs. Assocs.), 84 F.3d 1281, 1283 (10th Cir. 1996).

96 Id. at 1284.

97 Id. at 1285.

98 Id. at 1286.

99 Id. at 1286.

100 267 F.3d 340 (3d. Cir. 2001).
102) Id. at 345.
103) Id. at 357.
107) OHC Litig. Trust v. Credit Suisse (In re Oakwood Homes Corp.), 2009 WL 4829835 *2 n.1 (3rd Cir. Dec. 16, 2009) (noting that the Third Circuit’s application of in pari delicto is a minority approach but stating, “[h]owever, we are bound by our precedent.”).
114) 56 F.3d 750, 754 (7th Cir. 1995).
115) Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995) (emphasis added).
116) Id. at 752.
117) Id. at 754.
118 Fisher v. Apostolou, 155 F.3d 876, 880 (7th Cir. 1998).
119 Federal Deposit Ins. Corp. v. O’Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (per curium).
120 Id. at 19 (emphasis added).
121 Id. See Risa L. Wolf-Smith, Innocent Trustee/Creditors Barred by Debtors’ Past Wrongs: It Just Ain’t Right, 26 AMER. BANKR. INST. J. 42, 43 (2007).
123 Federal Deposit Ins. Corp. v. O’Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (per curium).
125 Id. at 362.
126 Id. at 362.
129 Id. (citing Segal v. Rochelle, 382 U.S. 375, 380 (1966)).
132 Id. at 324-27.
133 Id. at 312-16.
134 Id. at 327-28.
135 Id. at 309.
136 Id. at 327-28.
139 402 F.3d 833, 836-37 (8th Cir. 2004). See also Jeffrey Davis, Ending the


142 Id. at 535-38.


147 See supra diagram.


156 Id. at 327 n.14.

157 See infra discussion of proposed federal common law rule.


159 Id. at 366.

160 “[T]he primary Erie doctrine dictates that federal courts may not declare federal common law in those areas beyond Congress’s legislative power (or some other federal power under the Constitution.)” Thomas E. Plank, The Erie Doctrine and Bankruptcy, 79 NOTRE DAME L. REV. 633, 662 (2004).


165 Id.

166 Id. at 83 n.2.

167 Id. at 81-82.

168 Id. at 88.

169 Id. at 88 (citations omitted).

170 Id. at 87 (citing Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63, 68 (1966)). See also Nisselson v. Learnout, 469 F.3d 143, 154 n.3 (1st Cir. 2006) (noting the possibility of creating a federal test of imputation but failing to consider its creation as neither party had requested one).

171 See supra discussion of judicial economy and unity of creditors.

172 See supra discussion of judicial economy and unity of creditors.


The bankruptcy clause of the Constitution gives Congress the power to “establish uniform laws on the subject of Bankruptcies throughout the United States.” U.S. CONST. art 1, § 8, cl. 4.


Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 TENN. L. REV. 47, 81-84 (2006).

Jonathan Witmer-Rich and Mark Herrmann, Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 TENN. L. REV. 47, 61 (2006).

See supra notes 66-68.

195 Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer’s Wrongdoing to a Bankrupt Corporation, 74 Tenn. L. Rev. 47, 86 (2006).

196 Id. at 88-91.

197 Id. at 88-91.


199 Id. at 873.

200 Id. at 873.

201 Id. at 902 (Rivera-Soto, J., dissenting).

202 Id. at 882.

203 Id. at 893 (Rivera-Soto, J., dissenting).

204 Id. at 882 (emphasis added).

205 Id. at 890.

206 Id. at 885 (citing Welt v. Sirmans, 3 F.Supp. 2d 1396, 1402-03 (S.D. Fla. 1997)).

207 Although negligence is usually not sufficient to maintain an action for aiding and abetting, it can be sufficient when the defendant third party has a duty to act. Since KPMG, as a third party auditor, had a duty to act, its negligence can support a claim for aiding and abetting breaches of fiduciary duty.


209 Id. at 896-97 (Rivera-Soto, J., dissenting).


211 NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 885 (N.J. 2006); See Samuel C. Wasserman, Note, Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers, 77 Fordham L. Rev. 365, 395 (2008) (noting that that the court could have made a rule that “when a third party has negligently contributed to a fraud and the guilty managers have been removed from the picture, the court decides that imputation is improper.”).

212 Thabault v. Chair, 541 F.3d 512 (3d Cir. 2008).

213 Id. at 516-17.
214 Id. at 517 (Following the death of the original defendant, one of the wrongdoing officers, Coopers, now PwC was substituted as the defendant.).
215 Id. at 529.
216 See infra discussion of the public policy prong.
218 Id. at 492-98.
219 Id. at 492.
220 Id. at 506.
221 Id. at 506.
222 Id. at 506. (The court “conclud[ed] that Pennsylvania’s Supreme Court would reject the notion that equitable defenses can never be raised against a trustee plaintiff but rather would allow a court applying Pennsylvania law discretion to bar use of the defense when under the circumstances presented, it concludes that its invocation would produce an inequitable result”) (citing Universal Builders, Inc. v. Moon Motor Lodge, Inc., 244 A.2d 10, 14 (Pa. 1968)) (“[T]he application of the clean hands doctrine to deny relief is within the discretion of the chancellor.”); Art Metal Works v. Abraham & Straus, 70 F.2d 641 (2d Cir. 1934) (L. Hand, dissenting), cert. denied, 293 U.S. 596 (1934), dissent adopted as opinion of the court on rehearing, 107 F.2d 944 (2d Cir. 1939) (per curiam), cert. denied, 308 U.S. 621 (1939). The Supreme Court suggests that the federal courts should predict how a state court of last resort would rule if the state law is unsettled on an issue. See O’Melveny & Myers v. Federal Deposit Ins. Corp., 512 U.S. 79, 90-91 (1994) (Stevens, J., concurring) (citations omitted).
223 267 F.3d 340 (3d. Cir. 2001). See also supra.
226 Id. at *5.
227 Id. at *6.
228 Id. at *16-*17.
229 Id. at *18.
230 Id. at *2. See also Am. Int’l Group, Inc. v. Greenberg (In AIG, Inc., Consol. Derivative Litig.), 965 A. 2d 763, 831 n.247 (Del. Ch. 2009) (Strine, V.C.) (dismissing claims against auditors by AIG without prejudice because the New York Court of Appeals has not ruled on point for the application of in pari delicto sufficiently and in the interim plaintiffs should be able to bring claims).


233 See Kirschner v. KPMG LLP, 590 F.3d 186, 194-95 (2nd Cir. 2009).


236 Employees benefit indirectly because the debtor is financially stronger and continue to employ them longer. Former management is often employed as the debtor in possession because they know the debtor better and therefore can run it more efficiently. See supra notes 101-103 and accompanying text.

237 See supra notes 25-34 and accompanying text.

238 Fed. R. Bank. P. §1007 (a). The exact contents of the schedule depend upon the chapter of filing and whether it was a voluntary filing.

239 See 11 U.S.C. § 362(a). The automatic stay is created to provide a debtor with breathing room and to ensure that the estate is as large as possible for the benefit of reorganization and the body creditors.

240 See ALAN N. RESNICK ET AL., 7 COLLIERS ON BANKRUPTCY ¶1100.01 (15th ed. 2003).

241 H.R. Rep. No. 595, 95th Cong., 1st Sess. 232-33 (1977). See also ALAN N. RESNICK ET AL., 7 COLLIERS ON BANKRUPTCY ¶1104.02 (15th ed. 2003). Allowing a debtor-in-possession to run the debtor can also be cheaper because the trustee does not need to be paid to do it.

SAVING INNOCENCE


248 Id. at 313.

249 Id. at 316.

250 Id. at 316.

251 Id. at 306 (quoting Black’s Law Dictionary 711 (5th ed. 1979)).


253 Id.

254 Id. at 139.

255 In re Edgewater Medical Center, 332 B.R. 166, 178 (Bankr. N.D. Ill. 2005) (“[T]he in pari delicto defense exists only because wrongdoers must not be permitted to profit from their wrongdoing.”).

256 Tanvir Alam, Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How In Pari Delicto Has Been Perverted to Prevent Recovery for Innocent Creditors, 77 AM. BANKR. L.J. 305, 327-28 (2003); See also Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995).

257 56 F.3d 750 (7th Cir. 1995) (Posner, C.J.).

258 348 F.3d 230 (7th Cir. 2003).

259 Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995).

260 Id. at 754-55.

261 Id. at 754-55.

262 Id. at 754.

See supra notes 248-254 and accompanying text. The actual conduct of the insiders should be considered here as opposed to in the first step because their complete removal would leave no reason to consider their wrongdoing.


See supra discussion of requirements for imputation.


See supra note 57.


that “where a defendant’s only sin is its failure to prevent transgressions by the plaintiff, no benefit flows to the public from rewarding the transgressor”).


277 *See supra* discussion of aiding and abetting generally and accompanying notes.


279 *See supra* note 252.


281 *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006); *Krasny v. Bagga (In re Jamuna Real Estate, LLC)*, 365 B.R. 540 (E.D. Pa. 2007). Both courts considered aiding and abetting fiduciary duty claims but did not use the federal law framework. *Edwards* found that Georgia did not recognize the tort of aiding and abetting and if it did, the same logic used in the RICO analysis would apply to the trustee’s claims. In *In re Jamuna*, the defendants apparently failed to plead that the trustee was *in pari delicto*.


283 *Id.* at 1148.

284 *Id.* at 1148.

285 *Id.* at 1155.

286 *Id.* at 1155.

287 *Id.* at 1155.

288 *Id.* at 1155. (citations omitted).

289 *Id.* at 1155.

290 *Id.* at 1156.

291 *Id.* at 1155.


293 *Id.* at 548.

294 *Id.* at 556-57.

295 *Id.* at 557.

296 *Id.* at 549.
“Under New York law, creditors are owed a fiduciary duty by officers and directors of a corporation only when the corporation is insolvent.” Cooper v. Parsky, 1997 U.S. Dist. LEXIS 3665 *22 (S.D.N.Y. Mar. 27, 1997) (emphasis added), rev’d on other grounds, 140 F.3d 433 (2d Cir. 1998).


311 “Under New York law, creditors are owed a fiduciary duty by officers and directors of a corporation only when the corporation is insolvent.” Cooper v. Parsky, 1997 U.S. Dist. LEXIS 3665 *22 (S.D.N.Y. Mar. 27, 1997) (emphasis added), rev’d on other grounds, 140 F.3d 433 (2d Cir. 1998).


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316 *Kirschner v. KPMG LLP*, 590 F.3d 186, 194-95 (2nd Cir. 2009)(Second Circuit certifying questions regarding *in pari delicto* to the New York Court of Appeals) (asking the New York Court of Appeals to focus on the questions regarding the adverse interest exception if they limit their answers).

317 *See supra* for discussion of the Second Circuit’s *Wagoner Rule* and its similarity to *in pari delicto*.


Investors and Employees as Relief Defendants in Investment Fraud Receiverships: Promoting Efficiency by Following the Plain Meaning of “Legitimate Claim or Ownership Interest”

JARED WILKERSON

Relief defendants are nominal, innocent parties who hold funds traceable to the receivership but have no legitimate claim or ownership interest in them. These nominal parties, as opposed to full or primary defendants, have no cause of action asserted against them, and if they show no legitimate claim to the funds traced to the receivership, the funds are disgorged — generally at summary judgment. This seemingly simple relief defendant tool is used by receivers and regulatory agencies to quickly recover receivership funds for ultimate distribution to creditors. Recently, however, conflict has arisen in federal courts concerning the meaning of “legitimate claim or ownership interest.” Where courts fail to uphold the plain meaning of those words, confusion and unpredictability ensue, leading to enormous costs for creditors as receivers, on the receivership’s dime, attempt to claw back funds from relief defendants. To prevent such unnecessary costs in the future, the plain meaning of “legitimate claim or ownership interest” must be reinforced to protect, at minimum, the amount of investors’ returned principal and the amount of employees’ reasonable compensation.
Imagine yourself as one of the tens of thousands of investors holding a certificate of deposit from Stanford International Bank in early 2009. The CD has the blessing of the SEC and CFTC and has performed beautifully for about 15 years. The broker-dealer, Stanford Group Company (“SGC”), is a member of SIPC and the whole operation, with its lavish headquarters in Houston and offices around the world, appears perfectly prosperous. Yet on February 17, 2009, you receive news that FBI agents have stormed SGC headquarters in an SEC investigation alleging fraud or even a Ponzi scheme at Stanford, and that the federal court for the Northern District of Texas has appointed a receiver, Dallas attorney Ralph Janvey, to clean up the growing insolvency mess. Most importantly, you discover that your SGC brokerage account with a New Jersey holding company has been frozen. Within days, the receiver hires an army of attorneys and accountants who all start billing their time to the receivership. You, confused and worried by the affair, wonder what will happen next.

Within days, Janvey sends you a demand letter saying that he wants all of your Stanford investment money, both principal and interest, for a pool that will give all investors a low pro rata distribution. You are stunned that the receiver would suggest that you simply hand over your contractual returns, especially since he is attempting to gain access to CD proceeds not only in your brokerage account, but also money sitting in your bank account, money that made your mortgage payments last year, and money that paid your daughter’s college tuition. You storm to your SGC financial advisor to find out what he knows and to ask him why he allowed you to invest in a fraud. He, who has also invested in the CD, tearfully promises that he knows nothing of the alleged fraud and says that the receiver plans to claw back all of his commissions, salary, and employee forgivable loans related to CD sales. He also tells you that the receiver has fired him and all other advisors. Worst of all, he says, the receiver plans to pursue

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both investors and advisors as “relief defendants” — a classification that will largely prevent you from defending yourself, even though the receiver does not claim that you did anything wrong. Now, confused more than angry, you hasten immediately to your attorney.

This ugly scene, slightly fictionalized, demonstrates the uncertainty facing innocent investors and employees in Ponzi schemes and other investment fraud cleanups. Most starkly displayed in the $8 billion Stanford matter, the idea of treating investors and employees as though they had no legitimate claim to their funds has been around for some time. Conversation on this issue has spread on news sites and through the blogosphere, but there is a surprising lack of academic literature examining the pros and cons of what seems at times to be either self-serving or capricious receiver action. This article clarifies and directs the conversation and will help prevent abuse of investors and employees in the future. The article begins with an introduction to and brief history of relief defendants — nominal parties who hold receivership funds but have no legitimate claim to them — in investment frauds.

Though the relief defendant concept is becoming well-known, it has been a contested legal concept for decades in fraud cleanups. Indeed, receivers, trustees, and judges have diverse opinions on whether investors and employees should ever be proper relief defendants and, if so, the amount of investment proceeds a receiver can claw back from them. Thus, the law of relief defendants is economically inefficient because it is unpredictable. Some problematic reasoning has already led to harsh outcomes for two of the most attractive clawback targets for receivers cleaning up financial frauds: investors and employees. In particular, the following should be antithetical to the law of relief defendants: (1) that investors, as relief defendants, can be made to disgorge the amount of principal they invested, and (2) that employees, as relief defendants, can be made to disgorge their reasonable remuneration.

The basis of these problems is a misunderstanding or misconstruction of “legitimate claim or ownership interest,” which is the key to determining whether a party is a proper relief defendant or must be pursued as a “full defendant,” that is, as a party whose unjust enrichment, receipt of a fraudulent conveyance, or other participation in or benefit from the fraud
allows for a cause of action (with its panoply of defenses) against her. This article next introduces these two problems by way of a few salient cases. After each problem, the obvious solution is discussed: to reinforce the idea that investors have a legitimate claim to their principal and that employees have a legitimate claim to their reasonable remuneration — even in Ponzi schemes. Clarification of the status of investors and employees will not only minimize economic hardship on innocent parties, but will also reduce the time that receivers (and defense attorneys) spend litigating, thereby leaving more of the receivership estate for distribution to creditors.

The legal problems then are illustrated, where the Stanford case is used to display the consequences of disregarding the plain meaning of “legitimate claim or ownership interest.” In that case, the receiver and his contingent of professional billers burned through money meant for investors and other creditors while fruitlessly pursuing other innocent investors and employees as relief defendants. If the relief defendant concept had been clearer, this likely would not have happened. Adhering to the plain definition of “legitimate claim” will lead to predictability and efficiency by discouraging unnecessary litigation, maintaining the size of the receivership estate, and providing for an earlier distribution of receivership funds to creditors. Receivers, incentivized by the pool of money sitting in receivership, will probably continue to push the envelope even after these particular problems are finally settled, but perhaps by helping to focus the discussion surrounding relief defendants in investment frauds, investors and employees will be saved from needless and costly attacks by misguided receivers.

A BRIEF HISTORY OF RELIEF DEFENDANTS IN INVESTMENT FRAUD RECEIVERSHIPS

A federal receivership in a securities fraud case is essentially the equity-based version of a bankruptcy trusteeship. That is, the receiver, appointed as an officer of the court, steps into the shoes of the directors and managers of the accused entity for the benefit of creditors — who begin to queue shortly after the receiver’s appointment. Rather than the web of bankruptcy code rules governing trustee behavior, receivers are governed
by broad equitable principles as defined in the receiver’s appointment order. Indeed, the need for equity and flexibility is identified in Federal Rule of Civil Procedure 66, which states that:

These rules govern an action in which the appointment of a receiver is sought or a receiver sues or is sued. But the practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts or with a local rule. An action in which a receiver has been appointed may be dismissed only by court order.

By handing decision-making in administration of the entity in receivership to courts following the “historical practice” of other courts, the drafters of the Federal Rules recognized the need to leave this area to case-by-case analysis and common law development. Although the common law does structure receivership dealings and precedent is important, “The district court has broad powers and wide discretion to determine relief in an equity receivership.”

The principles governing equity receivers are usually reflected in the receiver’s appointment order by the trial court handling the enforcement matter. Ordinarily, appointment orders broadly state that the receiver’s duty is to retain and recover assets of the entity in receivership for the benefit of the creditors of that entity.

**Relief Defendants**

Relief defendants are “part[ies] to an action who ha[ve] no control over it and no financial interest in its outcome….” Since relief defendants, mere custodians or gratuitous recipients of funds, have no stake in the outcome and are accused of no wrongdoing or unjust enrichment, receivers can, by summary judgment, disgorge funds from them without asserting a cause of action as long as the relief defendants cannot show a legitimate claim to the funds.

By contrast, full defendants are parties who must be given full service of process, pursued under some cognizable cause of action, and must be afforded the ability to fully litigate his liability under that cause of action.
Naming a party as a relief defendant cannot be used as a quick way of obtaining disgorgement from a party if that party has an interest in the funds or is a wrongdoer; such parties do not fit the definition of a relief defendant and must be pursued as full defendants under some cause of action that affords full defensive rights.\textsuperscript{17}

In the receivership context, the procedural tool known as a “relief” or “nominal” defendant is one who:

[H]as no ownership interest in the property that is the subject of litigation but may be joined in the lawsuit to aid the recovery of relief. A relief defendant is not accused of wrongdoing, but a federal court may order equitable relief against such a person where that person (1) has received ill-gotten funds, and (2) does not have a legitimate claim to those funds…. A “nominal defendant” is a person who can be joined to aid the recovery of relief without an additional assertion of subject matter jurisdiction only because he has no ownership interest in the property which is the subject of litigation. Because a nominal defendant has no ownership interest in the funds at issue, once the district court has acquired subject matter jurisdiction over the litigation regarding the conduct that produced the funds, it is not necessary for the court to separately obtain subject matter jurisdiction over the claim to the funds held by the nominal defendant; rather, the nominal defendant is joined purely as a means of facilitating collection. In short, a nominal defendant is part of a suit only as the holder of assets that must be recovered in order to afford complete relief; no cause of action is asserted against a nominal defendant.\textsuperscript{18}

Often — and particularly when there are many relief defendants — the court will institute summary proceedings to decide whether the relief defendants have a legitimate claim to the funds they hold and, if they do not, to quickly disgorge the funds.\textsuperscript{19} There is no need for relief defendants to show exclusive ownership of the disputed funds to avoid disgorgement; they must generally show only some legitimate claim or ownership interest (beyond mere possession) to prevent summary disgorgement.\textsuperscript{20} In plain language, a “legitimate claim” is merely “any right to payment… even if contingent
or provisional” that is lawful, genuine, or valid; an ownership “interest” is simply a “legal share in [ownership]; all or part of a legal or equitable claim to or right in property.” An innocent employee who earns remuneration and can show that the remuneration is reasonable — that is, that the payment does not so far outweigh services rendered so as to become a gift or mere transfer of funds — clearly has a legitimate claim, arising out of the employment relationship, to the compensation. Likewise, an innocent investor always has a legitimate claim to investment returns up to the amount of her principal invested, and, in many situations — such as when debt holders are contractually promised a fixed rate of return — investors must be seen to have a legitimate claim to interest as well.

The quintessential relief defendant is a bank or a trustee holding funds on behalf of others, the addition of whom as a nominal party has no effect on jurisdiction. For example, in SEC v. Absolutefuture.com, defendants, after acquiring funds fraudulently, placed those funds into an account with relief defendant Exchange Bank & Trust, Inc. Since the relief defendant was merely holding funds that, for its purposes, belonged to someone else, it had no legitimate claim or ownership interest in them.

The relief defendant concept, though very simple on its face, has not had much time to develop, so it is perhaps understandable that the courts have varied so widely in its application. True, the SEC began using the nominal defendant concept in a limited way decades ago, using it as a tactic to add a needed party, such as the corporation itself, which would often align itself with the SEC’s position. Today, however, relief defendants are used in cases initiated by the SEC, CFTC, and other agencies as a means of quickly obtaining funds that belong to the receivership but are being held by someone else in a merely custodial or possessory capacity. Reaching this point, which is still unstable, has taken time. One major turning point was the SEC v. Cherif case, which demonstrates that the stage was set by 1991 to use the relief defendant tool not just as a means of adding entities as procedurally nominal parties but for clawbacks against individuals who had received funds originally obtained by fraud. The court in Cherif, faced with a nominal defendant who might well have provided services in return for compensation, inadvertently gave birth to confusion, and parties on both sides of the debate on the breadth of the
relief defendant tool use Cherif to bolster their position.

In that case, defendant Danny Cherif, an ex-employee of a Chicago bank, used his still-functional employee magnetic identification card to enter the firm’s building outside working hours, obtain confidential information about the bank’s corporate clients, and then trade on the stock market using that information before it went public. As part of his scheme, he opened a brokerage account in the name of his brother-in-law, nominal defendant Khaled Sanchou. The SEC obtained a preliminary freeze on the account and sought to disgorge any money from it that was connected to Cherif’s fraud. Sanchou argued that the freeze must be lifted because the district court had no jurisdiction over him. The Seventh Circuit held that subject matter jurisdiction would not be a problem for the SEC if Sanchou truly was a nominal defendant:

Because the nominal defendant is a “trustee, agent, or depositary,” who has possession of the funds which are the subject of litigation, he must often be joined purely as a means of facilitating collection. The court needs to order the nominal defendant to turn over funds to the prevailing party when the dispute between the parties is resolved. A nominal defendant is not a real party in interest, however, because he has no interest in the subject matter litigated. His relation to the suit is merely incidental and “it is of no moment [to him] whether the one or the other side in [the] controversy succeed[s].” Because of the non-interested status of the nominal defendant, there is no claim against him and it is unnecessary to obtain subject matter jurisdiction over him once jurisdiction over the defendant is established.

Noting that the factual record was insufficient to conclude that Sanchou had no hand in the scheme or otherwise was an uninterested party, the Court remanded and said that the district court should come to one of two conclusions: either that (1) Sanchou was an innocent custodian of the funds, in which case he would be a proper relief defendant and subject matter jurisdiction would be irrelevant; or that (2) Sanchou had a hand in Cherif’s scheme, and the preliminary freeze would have to be vacated, after which the SEC could amend its complaint to state a claim directly
against Sanchou and freeze the account again as it sought relief. Thus, the court assumed that Sanchou either had no legitimate claim to the funds or that he was a wrongdoer.

The problem with Cherif is the Seventh Circuit’s willingness to have the lower court apply the relief defendant label to Sanchou, who may have been — rather than an innocent party with no claim to the funds — an investor or an employee with an ownership interest in the funds in his brokerage account. He could have both had a legitimate claim to the funds and been innocent. That is, Sanchou may have had an innocent agreement with Cherif to receive a portion of the trading proceeds in return for Cherif’s use of Sanchou’s name and his account — or he may have had a similar agreement to receive a salary in return for the service he was providing Cherif. Thus, Sanchou could have been an investor, an employee, or something between the two. The court, however, did not attempt to resolve this problem and thus left the relief defendant concept open to interpretation. The Seventh Circuit’s willingness to instruct the district court to add Sanchou as a nominal defendant without analyzing whether he had a legitimate claim to the funds made Cherif a ripe candidate for both attackers and defenders of innocent investors and employees in financial frauds.

Consequently, after Cherif, the relief defendant concept received further analysis, but what constituted a legitimate claim remained, and still remains, vague. Courts thus far addressing the issue agree on one thing: the definition of a relief defendant is a party against whom no wrongdoing is alleged but who holds receivership funds to which she has no legitimate claim or ownership interest. Thus, courts agree that relief defendants can only avoid disgorgement by summary judgment by showing a legitimate claim or ownership interest in the funds they hold. However, despite these basic agreements, interpretations still conflict. As shown below, the entire controversy revolves around the meaning of “legitimate claim or ownership interest.” If courts bend the meaning of these plain words, they can — and have — come to diverse and, importantly, unpredictable outcomes. Settling this meaning will mean less confusion, less litigation, less money in the receiver’s pocket and more in investors’ hands.
DEFINING “LEGALITIME CLAIM OR OWNERSHIP INTEREST” FOR INVESTORS AND EMPLOYEES

Cherif, in addition to the flexible nature of equity decisions, kept the door open for divergent views on how investors and employees should be treated when added as relief defendants. Some courts, such as the Sixth Circuit in SEC v. George, have inappropriately found that investors do not have a legitimate claim or ownership interest in, at a minimum, the amount of their principal investment. Other courts, acknowledging the plain meaning of “legitimate claim or ownership interest,” protect, at minimum, investors’ principal.

Likewise, some courts addressing employees as relief defendants summarily, and improperly, order disgorgement of the employees’ funds even though, as relief defendants, no wrongdoing is alleged against them. Other courts recognize that innocent employees have acquired a legitimate claim by providing services in return for compensation. The uncertainty for investors and employees added as relief defendants in investment frauds needs to be leveled by more authority in favor of the clear meaning of “legitimate claim or ownership interest.” The cost stemming from such uncertainty, as shown below, can be devastating to relief defendants.

Investors as Relief Defendants

The most important case holding that investor relief defendants are subject to summary disgorgement of both principal and interest is SEC v. George. There, Steven Thorn, Derrick McKinney, and Rick Malizia solicited 550 investors for what they advertised as secretive “European fixed-instrument securities, including medium term notes.” The investors were told that their investment would be pooled with others’ to reach threshold levels for preferred rates of return. In reality, no investment occurred and Thorn, McKinney, and Malizia pooled the money to pay monthly “returns” to investors and make lavish personal purchases for themselves. In short, it was a Ponzi scheme.

In addition to claims against Thorn, McKinney, and Malizia, the receiver sought summary judgment — in the form of clawbacks — against investor relief defendants. The receiver pursued investors for principal,
“interest” earned on the investments, and prejudgment interest in an attempt to gather receivership funds and distribute them on a pro-rata basis. The Southern District of Ohio agreed with the receiver that, even though no wrongdoing was alleged against them, the investor relief defendants had (1) obtained receivership funds to which (2) they had no legitimate claim. The court granted summary judgment to the SEC. Four of these relief defendants — Durietha Dziorney, Carl Jackson, Frederick Harris and Allen George — argued that they had a legitimate claim to the funds they received from the scheme.

Dziorney was Thorn’s fiancée during the scheme, but she, rather than investing, simply received nearly $100,000 in cash and gifts (including a $66,000 engagement ring) from Thorn’s pool of investor money; her arguments of legitimate claim were rightly rejected and the district court ordered her to disgorge the funds. Jackson, Harris, and George were each innocent investors, against whom no wrongdoing or complicity was alleged, whose investment proceeds (plus prejudgment interest) were clawed back. Jackson had invested $285,000 in the notes and received only $282,320 back. Although he was a “net loser,” the district court ordered him to disgorge the full $282,320 plus $70,721 in prejudgment interest. Harris, also a net loser, had invested $1,186,000 and received only $505,920 in return; the district court ordered him to disgorge the full $505,920 plus $139,867 in prejudgment interest. Finally, George, a net winner, had invested $37,000 and received $79,300 in return; the district court ordered him to disgorge the $79,300 plus $13,495 in prejudgment interest.

On appeal to the Sixth Circuit, the question for all four relief defendants was whether they had established a legitimate claim to the funds. No court has held that a gift gives rise to a legitimate claim, and Dzironey was properly made to disgorge her gifts. However, the Sixth Circuit was incorrect as to the three investor relief defendants. To order the three innocent investors to disgorge everything related to the investment scheme, plus prejudgment interest, the court had to ignore the plain meaning of “legitimate claim or ownership interest,” the definition of which must include contractual returns on debt.

After giving token recognition to the standard relief defendant definition by quoting Cherif and other cases, the Sixth Circuit stated that, “Each
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of the relief defendants in this instance received ill-gotten funds and had no legitimate claim to those funds."\textsuperscript{52} The court then said, “Jackson, Harris and George [ ] received ill-gotten funds from the defendants. While each of the three invested his own money in Thorn’s investment scheme, the SEC showed that the money they received from the scheme came \textit{not from profits on their investments but from the investments of others.}”\textsuperscript{53} This focus on tracing scrambled the plain meaning of “legitimate claim.”

Tracing one’s profits to one’s principal has never been necessary to establish ownership over investment proceeds, and such a requirement is unforeseen and onerous from an investor’s view. Yet tracing was the only method, in the Sixth Circuit’s eyes, by which the investors could have established a legitimate claim:\textsuperscript{54} “[Jackson, Harris, and George] failed to come forward with any evidence rebutting the SEC’s tracing evidence. To survive summary judgment in the face of the SEC’s evidence, the relief defendants needed to present affirmative evidence, not just affirmative assertions, demonstrating a disputed issue of material fact. They did not do so.”\textsuperscript{55} Thus, the investors — two of whom received less than their principal investment — had to disgorge every penny, plus interest, that they had received according to contractual agreement, even though no wrongdoing was alleged against them. Thus, the court suggested that a person did not have a legitimate claim to the amount of his own investment and that, even in the absence of wrongdoing, an investor cannot prove a legitimate claim without tracing the dollars he received from the scheme to the dollars he placed into the scheme.

This obvious misuse of the relief defendant tool came in the misguided pursuit of equity. The Sixth Circuit, like the district court, wanted every creditor to receive 42 percent of their principal in accordance with the receiver’s distribution plan.\textsuperscript{56} Indeed, the court mandated total disgorgement even though it knew that Thorn had told potential investors before they invested that their money would be pooled with that of other investors in order to reach optimal, threshold levels of investment.\textsuperscript{57} Thus, investors knew from the outset — and the court knew before writing its opinion — that the money would be pooled and would not be traceable by investors. The court used traceability as the only factor determining whether an investor had a legitimate claim even though it knew that not a single investor could avoid disgorgement by tracing payout to principal. Thus, against plain meaning,
the court turned the expansive “legitimate claim or ownership interest” evaluation into a single-prong test for tracing. This move has helped keep the meaning of legitimate claim or ownership interest cloudy.

**Protecting Investors**

Investor relief defendants should be protected by courts’ recognition that innocent investors have a per se legitimate claim to their investment proceeds — at a minimum, the amount of principal invested. Probably the most important counterweight to George’s authority on this issue is *Janyey v. Adams*, which is addressed below. However, other courts have also adhered to the plain meaning of “legitimate claim or ownership interest,” finding that investors have a legitimate claim to funds stemming from their investments. For example, in *FTC v. Direct Mktg. Concepts, Inc.*, the court held that Lisa Mount, an investor and former employee of one of the companies in receivership, had to be protected from disgorgement. The corporation, which was allegedly used as part of a fraudulent infomercial scheme, made distributions to Mount, but there was no evidence that the distribution was anything but a legitimate return on her investment in the corporation. Thus, the funds could not be disgorged since there was significant doubt regarding the nature of the distribution. In this instance, the court properly recognized that, since there was a strong possibility that the distribution was not just a gift or siphoning of funds, Mount, as an investor, should be protected.

Other courts have similarly held, even in the context of full defendants against whom causes of action are asserted, that otherwise innocent investors have a claim to investment funds. For example, in *Johnson v. Studholme*, the receiver claimed, among other things, that the investors in a Ponzi scheme investigated by the CFTC had not given value for their returns on investment. The court disagreed, finding that the investors had given value for their entire returns:

There was…no allegation that the defendants received these payments with anything less than a good faith belief that it was a legitimate return on their investment as part of a contractual relationship…. The plaintiffs’ contention that the defendants were not purchasers for value
is...wrong because the value given by the investors was, of course, their contributions and the risk that they may lose all or part of their investment. While the scheme may have been illegal, from an economic perspective there is no doubt that the innocent investors gave value. They did all that was asked of them in the representations which induced their investment.\(^61\)

In *Chosnek v. Rolley* the receiver attempted to claw back investors’ returns on the theory of unjust enrichment, but the court protected investors’ principal: “[A]n innocent investor in a Ponzi scheme is not unjustly enriched when he receives returns on his investment in good faith and while ignorant of the scheme, so long as the returns do not exceed the amount of the original investment. To the extent of the original investment, such are not subject to claims made by later investors on the theory of unjust enrichment.”\(^62\) Even though the theories against them are similar, the legitimate claim requirement should be more easily met for relief defendants than full defendants being pursued under unjust enrichment or fraudulent transfer claims, since relief defendants are usually defrauded already and they are not allowed full defensive protections. As the Eleventh Circuit noted, “It would be difficult for equity to permit the Receiver to bring money into the receivership from someone who was defrauded…. In effect, equity would be sanctioning further torment of a defrauded investor.”\(^63\)

### Employees as Relief Defendants

To demonstrate the arguments made when receivers or agencies attempt to claw back funds from employees, *SEC v. Infinity Group*\(^64\) and *SEC v. Amerifirst Funding*\(^65\) are examined. As with the investor context, problems have arisen in the employee-as-relief-defendant context when courts do not recognize that workers have a legitimate claim to the compensation they hold in return for services.

#### SEC v. Infinity Group

In *Infinity Group*, the Eastern District of Pennsylvania started on the right foot: with the proper definition of a relief defendant.\(^66\) However, it
refused to acknowledge that the principal’s wife, Susan Benson, had any legitimate claim to the funds she held and presumably worked for. To reach this point, the court recognized that Mrs. Benson may have worked for the funds, but stated that, “[T]o the extent Susan Benson earned any of the funds which were transferred into these trusts, she did so in the service of the very unlawful offering and sale of securities which is the subject of these proceedings. It would be contrary to the securities law to allow Mrs. Benson to launder the proceeds of a securities fraud by billing bilked investors for services rendered in furtherance of that fraud. Illegal consideration is invalid consideration and thus cannot shield ill-gotten gains from disgorgement.”

Although the court likely arrived at the correct outcome (Mrs. Benson probably was a wrongdoer or co-conspirator), it did so by misapplying its own definition of relief defendant in two ways: first, Mrs. Benson stated a legitimate claim to the funds; second, the court imputed wrongdoing to her. Either of these misapplications should be enough to place a party outside the relief defendant realm, and the Infinity Group court created enormous uncertainty by overlooking its two obvious missteps. If Mrs. Benson worked for the money, which the court seemed willing to accept, she had stated a legitimate claim. Further, there is no question that the court considered Mrs. Benson to be a wrongdoer — indeed, a launderer. However, a relief defendant is, by definition, accused of no wrongdoing. Since Mrs. Benson convinced the court that she might have worked for the funds, she should have been released as a relief defendant and pursued as a full defendant with full defensive rights, rather than being summarily deprived of her assets. The court overlooked a legitimate claim — which Mrs. Benson articulated — in favor of potential wrongdoing, thereby muddling the relief defendant concept and keeping the door wide open for suits against employees.

In addition to confusing a legitimate claim with wrongdoing, the Infinity Group court created an untenable standard for summary disgorgement: if a person has been “in the service of the very unlawful offering and sale of securities which is the subject of [the] proceedings,” she has no legitimate claim to the funds she holds. Presumably, this broad definition could be applied to anyone who supports an unlawful offering, whether they
know the offering is unlawful or not. Under this standard, everyone from officers and directors to gardeners and janitors could be subject to summary disgorgement.

**SEC v. Amerifirst Funding**

In *Amerifirst Funding*, Jeffrey Bruteyn and others orchestrated an investment fraud through closely-held, affiliated corporations. Hess Financial was one of these corporations, and it provided consulting services to Bruteyn’s Amerifirst Group, which was in receivership. Hess was added as a relief defendant, with the SEC seeking to disgorge any money that Bruteyn had fraudulently obtained and then used to pay for consultations. The district court for the Northern District of Texas issued a default judgment against Hess, and in the later disgorgement quantification order, the court explained its reason for complying with the SEC’s wishes: “Because (1) the AmeriFirst entities paid Hess Financial with ill-gotten funds from investors who purchased the illegal SDOs [(self-directed investment options)] and (2) Hess Financial does not have a legitimate claim to these funds, Hess Financial should disgorge the ‘consulting fees’ it received from the AmeriFirst entities. Although Hess Financial might have had a legitimate claim to ‘consulting fees’ had it been unaware that its consulting services were furthering securities fraud, Hess Financial cannot invoke a good faith defense because its head, Bruteyn, was a principal actor in the securities fraud scheme.”

As with *Infinity Group*, the court almost undoubtedly arrived at the correct outcome — that is, since Bruteyn headed Hess, the corporation could be imbued with knowledge of the investment fraud. However, in arriving there, the court misapplied the relief defendant tool. The court recognized that the consulting services provided, and the fees charged, to Amerifirst could have been legitimate and reasonable. Yet the court moved on to say that Hess was a knowing participant in the fraud, and that it could therefore not use a “good faith defense” — something reserved only for full defendants, as in a fraudulent transfer action where the defendant must prove not simply a legitimate claim but good faith and value.

Wrongdoers cannot be relief defendants, as the court noted in its own definition: “[T]he SEC may seek disgorgement from ‘nominal’ or ‘relief’
defendants who are not themselves accused of wrongdoing in a securities enforcement action where those persons or entities (1) have received ill-gotten funds, and (2) do not have a legitimate claim to those funds.\footnote{74}

Even though the court properly recognized this definition, it treated Hess as both a relief defendant and a wrongdoer — a move that is clearly incorrect and one that leads to confusion. If the court saw that Hess, knowing of Bruteyn’s fraud, had rendered services for payment, it should have dismissed him as a relief defendant since he had a legitimate claim to the funds he held; the SEC could then have pursued Hess as a full defendant and wrongdoer. There are many doctrines under which Hess could have been pursued as a full defendant, including fraudulent transfer, unjust enrichment, or even violation of the securities laws. Instead, the court blended wrongdoing with the relief defendant tool. This blending keeps the door open for error and — the ultimate harbinger of economic wastefulness — uncertainty. Even if the court arrived at the correct result, it confused the relief defendant concept — inviting future litigation based on doubt that any particular relief defendant actually has a legitimate claim to the funds she holds.

**Protecting Employees**

Innocent employees have a legitimate claim to the funds distributed to them in return for their services. Although cases like *Infinity Group* and *Amerifirst* are establishing precedent against this proposition, others recognize this solid, predictable principle. More authority is needed to firmly establish it.

*Ross* is a very strong case for the plain meaning of “legitimate claim or ownership interest” for employees because it explicitly instructs regulatory agencies and receivers to avoid what likely was done in *Infinity Group* and *Amerifirst Funding*, viz. finding no legitimate claim because the relief defendant might be a wrongdoer.\footnote{75} In *Ross*, relief defendant Ernest Bustos, an ex-salesman of the entity in receivership (a company selling interests in payphones), appealed an order from the District of Oregon that he disgorge all of his commission payments.\footnote{76}

The Ninth Circuit first noted that summary proceedings against relief defendants — including low standards for service of process and es-
tablising personal jurisdiction, and summary disgorgement if there is no showing of a legitimate claim to the funds — were fair and helpful in marshaling the assets of a receivership, but only as long as those pursued fell cleanly into the definition of a relief defendant. The court noted that Bustos clearly had a legitimate claim to the funds: “Bustos appears to be no different from any other employee or vendor: he received compensation in return for services rendered. As such, he has presumptive title to those commissions, and unless the Receiver can prove otherwise, it is likely that the Receiver can disgorge those commissions only by showing that Bustos has himself violated the securities laws.”

After establishing that Bustos was not a proper relief defendant because he had a legitimate claim to the funds, the court went on to reprove the receiver and the SEC for suggesting that Bustos should disgorge his commissions because he was a wrongdoer in the fraud. Noting that the SEC had many options by which to pursue wrongdoers and that relief defendant disgorgement was not one of them in this instance, the court said, “However the Receiver or the SEC chooses to proceed, we admonish both to avoid improper shortcuts. Unless they can articulate some theory of liability that does not turn on Bustos’s own violation of the securities laws, they must formally serve him with process, properly obtain in personam jurisdiction over him, permit him to litigate fully all issues relating to both the fact and scope of his liability, and do so, of course, subject to all available legal and equitable defenses.”

Thus, the court recognized that the SEC had violated two of the facets of the relief defendant definition: that a relief defendant has no legitimate claim to the funds and that a relief defendant is not a wrongdoer. The court did not, as others have done, mix the concepts of legitimate claim with wrongdoing, noting instead that a wrongdoer has the right to the due process and defensive mechanisms offered to all full, or primary, defendants. Thus, Ross is a major piece of the firewall being built up against cases like George, Infinity Group, and Amerifirst Funding. By following the reasoning in Ross, other courts would not only recognize that employees have a legitimate claim to their remuneration, but also that such employees, if wrongdoers, have to be pursued as full defendants with the ability to defend themselves.
CFTC v. Walsh: A Template for Reasonably Deciding the Legitimate Claim Question in Any Context

General principles should apply whenever a court is deciding whether a relief defendant has a legitimate claim to the funds at issue. CFTC v. Walsh is among the best examples of a court’s grappling with the plain meaning of “legitimate claim.” There, Ms. Schaberg, the wife of the supposed fraudster Walsh, was added as a relief defendant in a case by the SEC and CFTC against her husband and his business partner. The funds and luxury items the SEC and CFTC sought from Schaberg were traceable to Walsh’s misappropriation of his clients’ funds, but Schaberg had acquired them in a divorce settlement agreement from Walsh some three years before the SEC and CFTC brought suit against him. The question, therefore, was whether Schaberg had acquired a legitimate claim to the funds by signing the settlement agreement in which, she argued, she gave up legal claims against her husband in return for the assets.

The court admitted that it had never constructed guidelines on what constitutes a legitimate claim or ownership interest. Attempting to form a baseline, it accepted the notion that if Ms. Schaberg could establish that the foregoing of her legal claims was in good faith and valuable, then her assets would be protected from disgorgement — at least until she was pursued under some other theory.

Ultimately, the court had to certify questions to the New York Court of Appeals rather than solve them itself since, taking the relief defendant concept seriously rather than imputing Schaberg with wrongdoing or otherwise foregoing analysis, it recognized that the matters of value and property were state law questions for which it had no answer. Even though the court did not reach a final resolution, this case is a prime illustration of how courts should conscientiously approach the legitimate claim question: first, the court set reasonable parameters, based on other cases, as to what could be considered a legitimate claim under the plain meaning of that term. It recognized that, on one hand, gifts from a spouse — as in George — would not give rise to a legitimate claim while noting that, on the other hand, receiving compensation for services rendered to an employer or purchasing assets for value would give rise to such a claim. Second, after setting these parameters, the court did not avoid the meaning of a legitimate claim by
imputing wrongdoing to the relief defendant or order disgorgement simply because the regulatory authority sought it. Instead, it engaged in thoughtful and serious analysis of what, under law and clear meaning, constitutes a legitimate claim. Recognizing that it could not, even in equity, go further, it turned the questions over to the state court for help.91

As long as courts do not gloss over the meaning of “legitimate claim or ownership interest,” they will likely either come to a reasonable conclusion that stems from the words themselves and the legal standards they represent (as in Ross), or reach a point at which they can go no further (as in Walsh). In the context of relief defendant employees and investors in fraudulent schemes, however, the way forward is clear in, almost certainly, every case: courts should find that remuneration and principal invested give rise to a legitimate claim. If the parties then can be sued as full defendants under fraudulent transfer, unjust enrichment, or fraud claims, then so be it, but a party holding remuneration for services or investment principal cannot be a proper relief defendant. There can be no other reasonable reading of the agreed-upon language.

**SEC V. STANFORD INTERNATIONAL BANK: AN ILLUSTRATION OF THE LEGITIMATE CLAIM CONFUSION AND ITS COSTS**

Receivers, who are officers of the court appointing them, exist to benefit investors and other creditors.92 Yet when receivers (or regulatory agencies, who are often the named plaintiffs in such suits) ignore the plain meaning of “legitimate claim or ownership interest” to pursue investors’ principal or employees’ remuneration by adding these parties as relief defendants, problems arise. If the receiver loses, he hurts creditors of the current receivership through misguided and wasteful litigation; if he wins, he hurts creditors of future receiverships by creating or perpetuating uncertain definitions. In litigation stemming from SEC v. Stanford International Bank,93 the receiver — relying on flawed precedent such as George — was ultimately prohibited from seeking disgorgement from investors as relief defendants. This prohibition indicated to him that he would not prevail on relief defendant claims against employees, so he dropped those as well. The case presents a perfect opportunity to illustrate the conse-
quences, both in terms of legal arguments and practical, economic costs, of the uncertainty created by cases like *George*.

**Background and Law in Janvey v. Adams**

The Department of Justice, through a grand jury, indicted R. Allen Stanford (the sole shareholder and chairman of Stanford Financial Group, including Stanford International Bank) and his closest confidants and officers in June 2009 for violations of securities laws by running a massive Ponzi scheme. Ralph Janvey, the SEC-picked equity receiver of Stanford Group Company (a Houston-based broker-dealer subsidiary of Stanford Financial Group with its own subsidiary corporations) was appointed by the Northern District of Texas in February 2009. The court directed him to recover traceable receivership assets for the benefit of investors and other creditors. Janvey immediately froze investors’ and employees’ brokerage accounts and funds traceable to Stanford Financial Group in other places. He then fired the employees.

Although the *SEC v. Stanford* family of cases (both the SEC and ancillary suits) is large and growing, *Janvey v. Adams* is the most important relief defendant battle of the group — and possibly the most important relief defendant case since *George*. There, the receiver, in an action ancillary to the SEC suit, attempted to claw back investor relief defendants’ principal and employee relief defendants’ compensation before the Northern District of Texas and, on appeal, before the Fifth Circuit. Only the issue of investor relief defendants was reached by the Fifth Circuit, although much of the same reasoning would apply to employee relief defendants, as Janvey recognized when, after the Fifth Circuit’s decision, he released the employees and re-added them as full defendants to be pursued under unjust enrichment and fraudulent transfer (“UFTA”) claims.

The receiver’s freeze, which began in February 2009, ultimately encompassed some 32,000 accounts. After a few months, Judge Godbey of the Northern District of Texas recognized the freeze’s hardship on account holders, and ordered that the receiver either assert claims against holders or release their accounts by early August 2009. To keep their accounts frozen and hopefully claw back investment proceeds and remuneration, Janvey added as relief defendants hundreds of certificate of de-
posit (“CD”) investors and ex-Stanford employees who had sold those CDs. In his complaints against them, the receiver sought not only the investors’ interest, but also their principal invested (even from numerous “net losers,” or those who received less in investment proceeds than they had invested in principal); from ex-financial advisors he sought base pay, commissions, bonuses, and employee-forgivable loans. He rested his complaints on the notion that the investors and former employees had no legitimate claim to any of these funds because they were simply lucky, not meritorious, to have received payments from other investors’ and creditors funds before the scheme crashed down. The court-appointed independent examiner and the SEC itself quickly set themselves in opposition to Janvey’s attempts to disgorge so much from these already-harmed parties against whom no wrongdoing had been alleged. In fact, the SEC even requested that the receiver’s order be modified to disallow the receiver from pursuing clawbacks for investor’s principal. Despite firm opposition, Janvey plowed forward.

Under a firestorm of arguments against Janvey’s continued freeze and questionable pursuit of relief defendants, the district court held a hearing on July 31, 2009 in which the receiver, representatives of the relief defendants, the examiner, and the SEC all participated. The hearing’s main issue was the receiver’s motion to continue a freeze on hundreds of investor and employee relief defendants — including a freeze on many investors’ principal amounts received from Stanford. During the hearing, all parties (except the receiver) spoke against Janvey’s freeze on the investors’ principal, and argued that such funds should be released immediately. The SEC vociferously objected to Janvey’s actions, and Janvey himself stated that he had angered the SEC to such an extent by pursuing investors’ principal that he was certain never to be chosen as a federal equity receiver by the Commission again. When Judge Godbey issued his order, there were few surprises: he allowed the freeze to continue as to investors’ interest and he ordered release of investors’ principal amounts, but he stayed the release until August 13, 2009 to give the receiver an opportunity to seek from the Fifth Circuit an extension of the freeze pending appeal. Janvey received the extension, and the Fifth Circuit heard oral arguments on November 2.
At the hearing, the receiver based his argument — that he should be allowed to seek complete disgorgement from investors as relief defendants for the purpose of an ultimate, pro rata distribution — on only two cases: *George* and *CFTC v. Kimberlynn Creek Ranch.* The court found neither of these cases helpful to the receiver and instead construed them to support its ultimate holding that Janvey could not pursue investors as relief defendants at all. Indeed, the court actually determined that investors have a legitimate claim to all of their contractual investment proceeds — both principal and interest.

[T]he Receiver has failed to establish that the Investor Defendants lack a legitimate claim to the CD proceeds they received from the Stanford Bank. They are therefore not proper relief defendants…. It is undisputed that the Investor Defendants received the CD proceeds pursuant to written certificate of deposit agreements with the Stanford Bank, which granted them certain rights and obligations. There was a debtor-creditor relationship between the Investor Defendants and the Stanford Bank based on written agreements well before the underlying SEC enforcement action against Stanford and the resulting receivership and restraining order. This constitutes a sufficient legitimate ownership interest to preclude treating the Investor Defendants as relief defendants…. Therefore, the Receiver’s claims and motions as to the Investor Defendants [regarding both principal and interest] should have been denied completely.

The court found a legitimate claim in the debtor-creditor relationship, while quoting *Kimberlynn Creek Ranch* itself for another example: “[R]eceipt of funds as payment for services rendered to an employer constitutes one type of ownership interest and would preclude proceeding against the holder of the funds as a nominal defendant.”

No weight was given to whether payments to investors were traceable to each investor’s contribution. In fact, interest from a Ponzi scheme can never come from one’s own investment. Despite the obvious conflict with the Sixth Circuit’s definition of legitimate claim in *George*, which equated the term with tracing, the *Adams* court recognized no discrepancy between the two cases. It cited *George* as being consistent with its own holding —
but only for the nominal definition of relief defendants as parties with no legitimate claim to the funds they hold, not for the interpretation of “legitimate claim.”118 It is at that point that George and Adams diverge. The two cases (and nearly all other relief defendant cases) recognize the definition of a relief defendant, but they differ markedly in what constitutes a legitimate claim.

Commentators soon after Adams noted that the window of confusion had been left open.119 Still, the case is strong persuasive authority for the treatment of relief defendants in the future. With any luck, courts will begin consistently to recognize that the relief defendant definition does not allow for recovery of investors’ principal (as held in Adams) or employees’ remuneration (as Janvey recognized soon after the Fifth Circuit decision when he released the financial advisors as relief defendants).

The Practical, Economic Cost of Confusion

Janvey’s improper pursuit of relief defendants’ principal, though ultimately unsuccessful, produced four hardships for creditors, most of whom were investors in the CD: first, it extended the litigation period for investors and financial advisors, placing a burden on them to stay engaged and pay attorneys’ fees; second, the freeze denied hundreds of investors access to their accounts for many months, thus imposing opportunity costs on account holders; third, the pursuit delayed ultimate relief for all creditors; fourth, by draining receivership funds and directing them to the receiver’s pocket, it decreased the amount that creditors could be paid back. Inherent to these hardships is a conflict of interest for receivers: their job is to capture as much of the receivership estate as possible for distribution to investors, but they know that the more litigation they spawn, the longer they will be paid out of the receivership itself. Thus, in their zeal to recoup receivership assets, it may be easy for receivers to overlook the fact that, “To undo all of these transactions would cause incalculable harm to hundreds of people, at a staggering cost, for which no commensurate benefit would lie.”120 The purpose in illustrating these four issues is to give an idea of how much time and money could be saved in a case like Adams if receivers and courts adhered to the plain meaning of “legitimate claim or ownership interest.”
The First Problem: Extended Litigation

Extended, unnecessary litigation is an enormous financial hardship for investors who have already been defrauded. This financial hardship occurs in at least two forms: opportunity cost for time spent on one’s own defense, and direct cost paid to one’s attorney.

For months, Janvey and his team chased relief defendants who turned out to be improperly pursued. These months represent lost time for the relief defendants as well as lost money flowing to their defense attorneys. That is, investors not only lost promised proceeds from their investment; they also lost money paid to attorneys. This problem is especially acute with regard to net losers: these people are by definition already harmed by the fraud and should not be defending themselves at all unless they are wrongdoers themselves. Just as the Sixth Circuit should have recognized of Jackson and Harris in George, the net losers in Adams had a legitimate claim to what little amount was held in their accounts; they should not have been drained of even more money by paying attorneys’ fees and losing work hours while defending against the receiver’s attacks. But litigation was needlessly extended even for net winners and employees in the Stanford case — for many, from April until November 2009.

Although no data exist to precisely quantify these losses, according to the Examiner, Janvey was pursuing 913 relief defendants (investors and employees) when the Fifth Circuit ruled against him on November 13, 2009. Since many relief defendants found relatively low fees by joining a group headed by one attorney, a mean low of $1000 and a mean high of $2,000 per relief defendant is a very conservative but plausible estimate for the legal work undertaken for months on their behalf. As for opportunity cost, this article conservatively estimates a mean low of 30 working hours lost (almost two hours per week for those pursued from late July to November 13) and a mean high of 40 working hours lost (approximately two-and-a-half hours per week), at a low estimated mean rate of $40 per hour and a high mean of $50 per hour. This is in view of the fact that most relief defendants were officially pursued as such from July 28 to November 13 — even though the brokerage accounts of most added as relief defendants on July 28 had been frozen since February and they had been consulting with their attorneys well before being added to the...
suit. Using these very conservative numbers, it is estimated that the relief defendants lost between $913,000 and $1,826,000 in attorneys’ fees, and between $1,095,600 and $1,826,000 in opportunity cost, for a total loss of $2,008,600–$3,652,000.

These rough estimates demonstrate the cost, however well-meaning, imposed by the receiver on those he was meant to serve. Of course, the fact that the receiver was seeking considerably more from relief defendants for pro rata distribution than the few million dollars his actions directly cost them for pro rata distribution shows that his approach was not completely devoid of cost-benefit analysis. The point is that an understanding of the plain definition “relief defendant” likely would have saved investors and employees millions of dollars in attorneys’ fees and opportunity cost alone. That is, if Janvey could not have so easily molded the relief defendant concept into a George-esque argument, he probably would not have taken that losing stance in the first place.

The Second Problem: Account Freezes

In an account freeze that often accompanies an SEC investigation, those with frozen accounts lose two sources of value: first, they cannot, as they would normally, use their accounts to participate in the investments of their choosing because the funds in the account remain in indefinite limbo; second, since the funds cannot be invested, investors cannot use the funds themselves or lost investment proceeds for wealth accumulation or living expenses — indeed, some people (imprudently, perhaps) live day to day on their brokerage accounts and investment proceeds and are financially crippled by a freeze.

In February 2009, the court initially froze about 32,000 brokerage accounts with possible connections to the certificate of deposit, representing approximately $6 billion in assets; since one of the Stanford entities — Stanford Group Company, the Houston-based umbrella entity for which Janvey was receiver — was a registered broker-dealer, many of the accounts were trading accounts that had nothing to do with the CD under investigation. Thus, after sorting them, Janvey began requesting release of mutual fund accounts as well as those under $250,000 not tied to the apparent fraud. Later, Janvey requested release of thousands more accounts with no funds
traceable to the CD proceeds. Finally, the court set a deadline, saying that all frozen accounts must either be connected to a complaint or released by August 3, 2009. On July 28, 2009, Janvey issued a list of 563 investors and financial advisors with frozen accounts that he was adding as relief defendants. These investors represented a combined total frozen of $373,000,093. When the Fifth Circuit told Janvey that he could not pursue investors as relief defendants, it also told him that all investor accounts had to be unfrozen. Thus, on November 13, 2009, all accounts — except employee brokerage accounts — were available for release.

Conservatively then, the unnecessary freeze was of $373,000,093 in investor relief defendants’ accounts, which extended from July 28 to November 13, 2009. The 563 investors with frozen funds were harmed financially during the 16 weeks of improper freezing. Although this article does not attempt the incredibly complicated task of quantifying the harm stemming from investors’ inability to access or reinvest their money, receive regular payments from their investments, or regularly draw on their accounts to live, the damage is undoubtedly substantial.

**The Third Problem: Delay of Ultimate Distribution**

Investors, particularly debtholders, expect to have access to their investment proceeds. Of course, in a Ponzi scheme investigation or other case of investment fraud, investors will necessarily have to wait for regulators, the receiver, and the supervising court to work things out. However, when a receiver extends litigation by spending months seeking receivership funds from unfruitful sources, investors are kept unnecessarily from the ultimate distribution of the receivership for longer than necessary, thereby increasing investors’ economic loss by taxing the time value of their money.

Janvey caused delay in the ultimate distribution of the receivership by pursuing investors’ principal and employees’ remuneration in the relief defendant context. Since there will be no final distribution (although there may be some interim distributions) until the receiver has completed his work of garnering receivership assets, this delay was imposed on all Stanford Financial Group creditors, even those who were not relief defendants. When the dust finally settles, investors who did not happen to receive CD payments can only hope to receive a few pennies on the dollar, but hav-
ing to wait extra months because the receiver is chasing improperly-added relief defendants adds insult to injury and again implicates the time value of money. However, since the size and timing of the ultimate distribution are so uncertain, the time value of the distribution is also uncertain. When the numbers are known, the time value of the extra months spent trying to fruitlessly claw back investors’ principal will be considerable, regardless of the multiplier used.

**The Fourth Problem: Depletion of the Receivership Estate**

 Receivers are paid out of the very receivership they are trying to protect and enlarge. Thus, the longer a receiver files claims, the longer he and his team of attorneys, accountants, and others are paid; however, the more the receiver is paid, the less is available for final distribution to creditors.

By April 2010, Janvey had asked for a total of $53,330,000 in fees and expenses for him and his team. Nonetheless, receivers, as officers of the court, must have their fees approved by the court, and the court can adjust the receiver’s payment for services. Although each jurisdiction may have slightly different factors for deciding how much of a receivers’ fees to pay, in this instance the Northern District of Texas was governed by the “Johnson factors.” One of these factors is the “amount involved and the results obtained,” which gives some discretion to the court to discount a receiver’s application if the fee application is large compared to the amount available for distribution or if the receiver’s pursuit of funds is inappropriate. Using this and other factors, the court temporarily discounted all of Janvey’s fee applications by 20 percent, inviting him to reapply for the hold-back amount when the size of the recovered receivership became clearer.

In addition to the court’s 20 percent general discount, the court applied, partially accepting the argument of the SEC and the examiner, an additional 15 percent temporary discount to fees requested from June to November 2009, the period during which the receiver improperly pursued relief defendants. This extra discount reflected the lack of “results obtained” during the period, and showed the court’s tempered concern that a receiver should not be rewarded for charging down unfruitful paths. However, despite the 35 percent total discount for that five-month period, the receiver and his team still received over eight million dollars of receiver-
ship funds, and the lost 15 percent, like the general 20 percent discount, is potentially recoverable.

Thus, from the beginning of the receivership to the present, the receiver has been rewarded handsomely from receivership funds. In fact, at one point, Janvey had asked for approximately 34 percent of everything he had recovered from the estimated $8 billion scheme. Further, of the $53,330,000 requested from February 2009 until April 2010, he has to date been awarded about $41,820,000 — approximately 78.42 percent of the bill, which he claimed to be already cut by 20 percent before the court imposed its own 20 percent discount.

A receiver’s worth must be tied in part to the difference between the amount he gathers for distribution and the amount of the receivership estate that he burns through. In Janvey’s case, this ratio does not seem to be very high — much to the chagrin of investors, who are projected to receive very little. For relief defendants, where a receiver successfully pursues innocent investors’ funds for redistribution to other innocent investors, the best that can happen is that, if successful in his clawbacks, the receiver gets paid some of the money coming in while the leftover wealth gets redistributed. Of course, as against net winners in a Ponzi scheme, there is a strong equity argument in favor of this redistribution because anything beyond their principal comes from other investors, but this argument loses what appeal it has when applied to investors who received less than what they put into the scheme. If the relief defendant concept were clear, it is conceivable that the millions of dollars paid to Janvey and his team for their improper pursuit of relief defendants would have remained in the pockets of investors instead.

Thus, Janvey and his team, relying on a poor but available interpretation of the relief defendant tool, hurt investors by improperly engaging innocent and already-harmed parties in litigation, preventing these innocent parties from accessing their accounts, delaying ultimate distribution, and shrinking that distribution by burning receivership funds unnecessarily.

CONCLUSION

The meaning of a “legitimate claim or ownership interest” must be reinforced, particularly when obvious clawback targets are involved, such as
investors and employees of fraudulent schemes. With cases like *George, Infinity Group,* and *Amerifirst Funding* placing the plain meaning into confusion, other courts should take every opportunity to settle the definition on its unambiguous foundation, thereby promoting judicial and economic efficiency.

Virtually every case addressing them uses the same definition to describe relief defendants, but the meaning of one part of that definition (what constitutes a legitimate claim) still varies widely — even though words are clear on their face. This unpredictability leads to innocent investors and employees, often already harmed by fraud, being further drained by costly litigation and clawbacks. In *Adams,* investors’ and employees’ accounts were frozen for months while litigation, based on uncertainty of the plain meaning, dragged on, costing millions of dollars in fees and opportunity cost. These scenes, which have been repeated in other Ponzi scheme and financial fraud receiverships, will continue to play themselves out — with funds being drained from investors and flowing toward receivers — until courts calm the uncertainty by predictably interpreting the meaning of “relief defendant.” Of course, in cases of contractual relationships between the entity in receivership and debt holders, the proper course of action will be, as it was in *Adams,* to recognize a legitimate claim to both principal and interest amounts under the contract; as a baseline, however, courts should recognize that investors have a legitimate claim to their principal and that employees have a legitimate claim to their reasonable remuneration.

**NOTES**


firms — Baker Botts and Thompson & Knight — plus a business restructuring advisor, a forensic accounting and information technology expert, a brokerage specialist, a security consultant and a public relations firm.”). See also Receiver’s Motion for Approval of Interim Fee Application and Procedures for Future Compensation of Fees and Expenses and Brief in Support, SEC v. Stanford Int’l Bank, No. 3:09-cv-00298-N, (N.D. Tex. May 15, 2009) (detailing receivership expenses from Krage & Janvey, L.L.P.; Baker Botts L.L.P.; Thompson & Knight LLP; FTI Forensic and Litigation Consulting; Ernst & Young; Financial Industry Technical Services, Inc.; Strategic Capital Corporation; Pierpont Communications, Inc.; 3-4 South Square; Roberts & Co.; Altenburger; Osler, Hoskin & Harcourt LLP; Liskow & Lewis; and Dudley, Topper and Feuerzeig, LLP).


5 See generally Clifford Krauss, 1,000 Stanford Financial Workers Dismissed to Save Company Assets, NY TIMES, March 6, 2009, available at http://www.nytimes.com/2009/03/07/business/07stanford.html (“[Janvey] notified 1,000 employees of the Stanford Financial Group on Friday that their jobs were terminated in an effort to preserve the value of whatever resources were left in the company.”).

6 See Section IA, infra. Accord SEC v. Colello, 139 F.3d 674, 677–78 (9th Cir. 1998) (noting with approval the lower court’s requirement that where a relief defendant was added, that party had the burden of proving a legitimate claim to the funds in question; if no such claim could be asserted, the funds would be disgorged by summary judgment).

7 Although it does not involve relief defendants, a similar scene is playing itself out in the Madoff cleanup, with trustee Irving Picard bringing suit against investors who received more than they invested. See, e.g., Michael Rothfeld, Madoff Investors Brace for Lawsuits, WALL ST. J., July 26, 2010, available at http://online.wsj.com/article/SB10001424052748704719104575389141620473502.html.

8 This article assumes that receivers generally have the power to pursue relief defendants, even though they do not represent the SEC but instead stand in the shoes of the entities in receivership. For a discussion of the argument, including authority, that receivers cannot sue investors of the entities in receivership, see Brief of the Securities and Exchange Commission, Amicus
Some investors, like those in *Janvey v. Adams*, clearly have a legitimate claim under contract to both the amount of their principal and any interest they receive under fixed agreement. Other investors, perhaps equity investors subject to risks and who receive dividends or other payments out of corporate surplus and whose fortune rises and falls with the success of the entity in which they have invested, might reasonably be seen to have no legitimate claim to false dividends or interest.

See, e.g., *Scholes v. Lehmann*, 56 F.3d 750, 753–54 (7th Cir. 1995) (explaining that receivers and trustees are often given similar powers).

Although state courts often appoint receivers, many securities fraud receiverships are initiated at the request of the SEC or other agencies in a federal enforcement action. The focus is mainly on these federal equity receiverships, in which receivers are appointed by the United States district court handling the enforcement matter.

Another type of receiver, known as a statutory receiver, follows the guidelines set forth in the statute under which she is appointed rather than the court’s appointment order. *See, e.g., Kenworthy v. Hargrove*, 855 F. Supp. 101 n.4 (E.D. Penn. 1994) (secretary of banking became receiver of bank under Pennsylvania banking statute, which also specified her authority).


Black’s Law Dictionary (9th ed. 2009), nominal party.

See, e.g., *SEC v. Ross*, 504 F.3d 1130, 1142 (9th Cir. 2007) (“We do not believe that the Constitution permits the Receiver to use the nominal defendant designation to deprive one whose only plausible basis for liability is a violation of the securities laws of either his right to full and formal service of process or his right to fully litigate the question of his own liability under the securities laws.”) (emphasis added).
17 Id.
18 Janvey v. Adams, 588 F.3d 831, 834 (5th Cir. 2009) (internal citations omitted).
19 For a general discussion on summary proceedings in Ponzi scheme receiverships, see S.E.C. v. Elliott, 953 F.2d 1560, 1566 (11th Cir. 1992) (“Rule 56 of the Federal Rules of Civil Procedure gives the district court summary jurisdiction over all the receivership proceedings and allows the district court to disregard the Federal Rules.”) Claimants claiming prejudice by summary proceedings have the burden of proving it. In Elliott, investors who were summarily disgorged of their proceeds were denied procedural due process because they had no opportunity to rebut the receiver’s claims; see also S.E.C. v. Antar, 120 F. Supp. 2d 431, 433 (D.N.J. 2000), aff’d, 44 F. App’x. 548 (3d Cir. 2002) (rejecting relief defendants’ pleas for more discovery and disgorging the relief defendants of the funds in question).
20 See, e.g., Adams, 588 F.3d at 834 (there is no need for a relief defendant to demonstrate the full bundle of rights; much less is required to show a legitimate claim or ownership interest) (citing Kimberlynn Creek Ranch, 276 F.3d at 191; SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991); SEC v. Founding Partners Capital Mgmt., 639 F. Supp. 2d 1291, 1294 (M.D. Fla. 2009) Of course, even after being released as relief defendants and added as full defendants, the parties may be subject in some jurisdictions to common law or statutory claims that might claw back both principal and interest. See SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 88–89 (2d Cir. 2002) (citing cases); In re Burton Wiand Receivership Cases Pending in the Tampa Div. of the Middle Dist. of Fla., No. 8:05-CV-1856T27MSS, 2008 WL 818504 (M.D. Fla. Mar. 26, 2008) reconsideration denied, No. 8:05-CV-1856T27MSS, 2008 WL 1986182 (M.D. Fla. May 6, 2008) (holding that full defendant investors could be sued by the receiver under the theories of unjust enrichment and fraudulent transfer); cf. Donell v. Kowell, 533 F.3d 762, 777 (9th Cir. 2008) cert. denied, 129 S. Ct. 640, 172 L. Ed. 2d 612 (U.S. 2008); Scholes v. Lehmann, 56 F.3d 750, 758 (7th Cir. 1995) (protecting defendant investors’ principal). However, some cases use relief defendants in very odd ways. For example, in Antar, 120 F. Supp. 2d at 443, the court allowed the SEC to disgorge funds from relief defendants through summary judgment — using the Uniform Fraudulent Transfer Act against them, which is a cause of action that should be reserved only for defendants who have full procedural and jurisdictional rights. See SEC v. Ross, 504 F.3d 1130, 1142 (9th Cir. 2007) (holding that the SEC must
serve, obtain jurisdiction over, and give full procedures to, a party in order to bring an unjust enrichment cause of action against him, since his legitimate claim prevented him from being a relief defendant).

21 Black’s Law Dictionary (9th ed. 2009), claim; legitimate.

22 Id., interest.

23 See, e.g., Bacon v. Rives, 106 U.S. 99, 104, 1 S.Ct. 3, 6, 27 L.Ed. 69 (1882) (“[I]t is of no moment [to an executor] whether the one or the other side in [the] controversy succeed[s]” since the executor would not get the funds anyway); Farmers’ Bank v. Hayes, 58 F.2d 34, 36 (6th Cir. 1932) (board of trust, which had held the funds, made no claim on it and was therefore a nominal defendant); Colman v. Shimer, 163 F. Supp. 347, 350–51 (W.D. Mich. 1958) (holding that public estate administrator was merely a nominal party with no substantial legal interest in the controversy, and whose addition to the suit did not affect jurisdiction); SEC v. DCI Telecommunications, Inc., 122 F. Supp. 2d 495, 502 (S.D.N.Y. 2000) (defendant’s wife, who had no role in the fraud but received funds from it, was a constructive trustee and therefore a proper relief defendant); accord SEC v. Harden, 1:05-CV-354, 2005 WL 2649857 at *4–5 (W.D. Mich. Oct. 17, 2005) (relief defendants were not “custodians” who held money on behalf of others, and therefore had to be released as relief defendants).


25 See, e.g., SEC v. Quing N. Wong, 42 F.R.D. 599 (D. Puerto Rico 1967); SEC v. General Time Corp., 407 F.2d 65 (2d Cir. 1968); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir.1980) (“federal courts have inherent equitable authority to issue a variety of ‘ancillary relief’ measures [including those against third parties] in actions brought by the SEC to enforce the federal securities laws.”).

26 See, e.g., CFTC v. Foreign Fund, 2007 U.S. Dist. LEXIS 45895 (M.D. Tenn. June 25, 2007) (relief defendants failed to show a legitimate claim to the funds they held, and the funds were therefore disgorged by summary judgment); cf. SEC v. Ross, 504 F.3d 1130, 1142 (9th Cir. 2007) (holding that the SEC could not institute summary proceedings against a relief defendant where that party, as an employee of the investment scheme, had demonstrated a legitimate claim to the funds). Sometimes the SEC oversteps its bounds and attempts to impute wrongdoing — and liability — to relief defendants. See,
e.g., SEC v. Huff, Fed. Sec. L. Rep. P 95, 917 (S.D. Fla. September 30, 2010) (although some relief defendants were subject to disgorgement because they could establish no legitimate claim to the funds they held, they could not be held to be jointly and severally liable for damages since such an action would be “punitive and violates due process because the relief defendant has had no notice or opportunity to defend against charges of wrongdoing.”).

27 SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); for insight on the transition from nominal to relief defendants in SEC cases, SEC v. Colello, 139 F.3d 674, 675–76 (9th Cir. 1998) (noting that, as of 1998, only a few courts had allowed the SEC to sue nominal defendants to recover fraud proceeds).

28 Cherif, 933 F.2d at 406.

29 Id. at 407.

30 Id. at 413–15.

31 Id. at 414 (internal citations omitted).

32 Id. at 415.

33 See, e.g., Janvey v. Adams, 588 F.3d 831, 834 (5th Cir. 2009); CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 189–90 (4th Cir. 2002); CFTC v. Walsh, 618 F.3d 218, 225–27 (2d Cir. 2010); SEC v. George, 426 F.3d 786, 798–800 (6th Cir. 2005); Cherif, 933 F.2d at 414; SEC v. Ross, 504 F.3d 1130, 1141 (9th Cir. 2007); SEC v. Founding Partners Capital Mgmt., 639 F. Supp. 2d 1291, 1293–94 (M.D. Fla. 2009).

34 See, e.g., SEC v. Ross, 504 F.3d 1130, 1146 (9th Cir. 2007); George, 426 F.3d at 799.

35 As the Supreme Court stated in Brown II when explaining the concept of equity, “Traditionally, equity has been characterized by a practical flexibility in shaping its remedies...” Brown v. Board of Education, 349 U.S. 294, 299 (1955); see also Hecht Co. v. Bowles, 321 U. S. 321, 329–330 (1944) (“The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.”). However, courts sitting in equity do rely on precedent and persuasive authority, and where precedential and persuasive authorities are clear, predictability can exist in equitable decisions.

36 426 F.3d 786, 798–800 (6th Cir. 2005).

37 Although there is some contention whether pre-receivership interest
payments should be treated as part of the principal amount, courts are generally favorable to this simple, rational plan. That is, any payment made to an investor from a scheme that is later shown to be fraudulent, which is below her principal — whether it is called an interest payment or otherwise — should be treated as part of the principal amount for calculating legitimate claim and for determining pro rata payments out of the receivership. See e.g., SEC v. AmeriFirst Funding, Inc., No. CIV.A.3:07-CV-1188-D, 2008 WL 919546 (N.D. Tex. Mar. 13, 2008); SEC v. Byers, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009), aff’d, No. 10-312-CV, 2010 WL 4185097 (2d Cir. Oct. 25, 2010), and aff’d sub nom. SEC v. Malek, No. 09-3583-CV, 2010 WL 4188029 (2d Cir. Oct. 25, 2010).


See, e.g., CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 192 (4th Cir. 2002), SEC v. Ross, 504 F.3d at 1133 (9th Cir. 2007); CFTC v. Walsh, 618 F.3d 218 (2d Cir. 2010).

SEC v. George, 426 F.3d 786 (6th Cir. 2005).

Id. at 788.

Id.


George, 426 F.3d at 791.

As other courts have recognized, there is no need to demonstrate the full bundle of ownership rights to avoid disgorgement as a relief defendant; all that must be shown is a legitimate claim or ownership interest — something that undoubtedly is created by investing funds and receiving contractual returns on those funds. See, e.g., Janvey v. Adams, 588 F.3d 831, 834 (5th Cir. 2009) (citing Kimberlynn Creek Ranch, 276 F.3d 187, 191 (4th Cir. 2002); SEC v. Cherif, 933 F.2d 403, 414 (7th Cir.1991); SEC v. Founding Partners Capital Mgmt., 639 F. Supp. 2d 1291, 1294 (M.D. Fla. 2009) (A legitimate claim or ownership interest “does not require possession of the full bundle of ownership rights that may exist in various types of property.”)).

Tracing has not traditionally been important in Ponzi scheme receiverships. For example, in United States v. Durham, 86 F.3d 70 (5th Cir. 1996), the Fifth Circuit found that the district court had not abused its discretion by forcing pro rata distribution, even though the largest investors had traced their funds and wanted their principal back.

Here, the entity at issue was a close corporation, and Mount was a shareholder. For purposes of determining whether she had a legitimate claim, these facts make no difference and the court gave the proper analysis. To be a relief defendant, she must not have been accused of wrongdoing — not even wrongdoing imputed to an insider of a close corporation — and she must have been holding funds to which she had no legitimate claim. She was not accused of wrongdoing, but there was at least a possibility of a legitimate claim to the distribution, which may have been compensation or a dividend payment. Notwithstanding the fact that Mount was a shareholder in a close corporation, if she either worked for the money (which is possible under the facts and mentioned by the court) or received a return on investment, she had
a legitimate claim to the funds.

In this vein, it must be noted that investors’ principal is protected — as long as they invested reasonably equivalent value and received returns in good faith — even in the Uniform Fraudulent Transfer Act, which provides, in nearly every state, a cause of action (outside of the bankruptcy context) under which fraudulent transfers can be avoided. See, e.g., Fla. Stat. Ann. § 726.109 (West).


SEC v. Elliott, 953 F.2d 1560, 1569–70 (11th Cir. 1992), rev’d in part on other grounds, 998 F.2d 922 (11th Cir. 1993).


SEC v. Amerifirst Funding, No. 3:07-CV-1188-D, 2008 WL 1959843 (N.D. Tex. May 5, 2008); cf. CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 192 (4th Cir. 2002) (stating that services rendered to an employer is a way of demonstrating a legitimate claim); S.E.C. v. Founding Partners Capital Mgmt., 639 F. Supp. 2d 1291, 1293–94 (M.D. Fla. 2009) (a debtholder, with whom the entity in receivership had a longstanding loan agreement, had to be released because such a debtor-creditor relationship — like employment relationships spoken of in Kimberlynn Creek Ranch — “constitutes a sufficient legitimate ownership interest to preclude treating Sun Capital as a relief defendant.”).

Infinity Group, 993 F. Supp. at 331.

Id.

Id.

Amerifirst Funding, 2008 WL 1959843 at *1.

Id.

Id. at *5.

Id.

See, e.g., Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995) (Ponzi scheme receivership, in which receiver pursued full defendants under the Uniform Fraudulent Transfer Act, which requires that a defendant defend herself by showing that she entered into the investment in good faith and gave reasonably equivalent value for it).


Another case with analysis favorable to relief defendants attempting
to establish a legitimate claim based on the rendering of services (if not employment in the traditional sense) is *CFTC v. Sarvey*, No. 08-C-192, 2008 WL 2788538 (N.D. Ill. July 17, 2008), in which the court found that relief defendant Bonfitto (and his company, Bonfitto Trading) had provided services — in the form of risky trade guarantees over a long period — to the defendant Sarvey in return for compensation. The court noted that, “[T]he issue here is not who has the greatest right to the funds. Bonfitto and Bonfitto Trading are impled as nominal defendants. As such, the only question is whether they have any legitimate ownership interest in the property at issue. If they do, they may not be impled as merely nominal defendants…. Similarly, it is irrelevant whether Bonfitto and Bonfitto Trading acted in “good faith” in receiving the funds. Plaintiffs may not name parties as nominal defendants while also implying that they violated the law…. If the Commission wants to asserts [sic] that Bonfitto and Bonfitto Trading obtained the property by some means that implies complicity in wrongdoing, it should implead them as outright defendants, not nominal defendants.” *Id.* at 4–5 (citations omitted).

76 *SEC v. Ross*, 504 F.3d 1130, 1133 (9th Cir. 2007).
77 *Id.* at 1151.
78 *Id.* at 1142.
79 *Id.* at 1151.
80 *Id.*
81 *Id.* at 1142.
82 *CFTC v. Walsh*, 618 F.3d 218 (2d Cir. 2010).
83 *Id.* at 221.
84 *Id.* at 222.
85 *Id.* at 221–22.
86 *Id.* at 225–26.
87 *Id.* at 226–27. Although the court mixes fraudulent transfer law with the relief defendant concept, it does so only to analogize and to help determine what a legitimate claim might mean in this particular instance.
88 *Id.*
89 *Id.* at 228–29.
90 *Id.*
91 *Id.* at 230–231.
92 See, e.g., *Scholes v. Lehmann*, 56 F.3d 750, 755 (7th Cir. 1995).

95 Although Janvey was appointed receiver of the entire SFG umbrella, the headquarters of Stanford International Bank were in Antigua — which is where all of the records and books were. Antigua appointed its own liquidators with possession of the bank’s records, and Janvey battled with the Antiguan liquidators for some time; in fact, Janvey struggled for months to be recognized as the authoritative receiver in such countries as Canada and the UK — each of which had significant Stanford assets. Who is recognized to represent SFG in different countries is still unclear. This turf war made work cumbersome for Janvey, because instead of having the bank records, he and his high-paid team had to sort through SGC records, some of which had little or nothing to do with SIBL. For an explanation, and documentation, of these struggles for jurisdiction, see the Examiner’s website, Examiner — Stanford Financial Group, under the heading “Petition for Recognition by Antiguan Liquidators of SIB,” http://www.lpf-law.com/sub/stanford.jsp (last visited Dec. 4, 2010).

96 Amended Order Appointing Receiver, supra note 1.

97 Janvey v. Adams, 588 F. 3d 831, 833 (5th Cir. 2009).


103 See generally Receiver’s Amended Complaint Naming Relief Defendants
at 2, No. 03:09-CV-0724-N (N.D. Tex. July 28, 2009); see also Brief of Appellant Ralph S. Janvey, No. 3:09-CV-0724-N (5th Cir. Sept. 11, 2009).

104 Id. (“CD Proceeds — loans, commissions, bonuses or other compensation paid to financial advisors for selling CDs, and interest or redemptions to investors — are little more than stolen money and do not belong to persons who received such funds but belong instead to the Receivership Estate.”).

105 Id. at 13 (“Relief Defendants do not have any rightful ownership interest that could justify their retaining possession of these funds, which are properly considered assets of the Receivership Estate.”).

106 Plaintiff’s Emergency Motion to Modify Receivership Order, SEC v. Stanford, No. 3:09-cv-0298-N (N.D. Tex. July 20, 2009). The SEC said that it should be the only party with power to pursue clawbacks from relief defendants and that the receiver’s misinterpretation of the law, which, Janvey argued, permitted him to seek principal, was harming investors. Given the SEC’s firm stance that principal was protected but interest was not, the Fifth Circuit’s ultimate ruling — that investors had a legitimate claim to both principal and interest — may have been an unforeseen boon for investors.

107 See generally Transcript of Oral Arguments before the Fifth Circuit Court of Appeals, Janvey v. Alguire, No. 09-10761 (5th Cir. Nov. 2, 2009) (SEC attempted to prevent Janvey from seeking investors’ principal by seeking a modification to his order).


111 Order Extending Injunction, Janvey v. Alguire, No. 09-10761 (5th Cir. August 11, 2009); Order Extending Injunction, Janvey v. Letsos, No. 09-107615 (5th Cir. August 11, 2009).

112 Transcript of Oral Argument Before the Fifth Circuit Court of Appeals at 1, Janvey v. Alguire, No. 09-10761 (5th Cir. Nov. 2, 2010). The only party at oral
argument to claim that investors had a legitimate claim both to principal and interest was Michael Quilling, an ex-receiver and attorney for various investor relief defendants. *Id.* at 41. The Examiner only advocated that investors keep up to their principal amount. *Id.* at 31. The SEC focused on the freeze, saying that it should be lifted because the receiver could not fulfill the elements of a preliminary injunction. *Id.* at 44–47. Thus, the Fifth Circuit’s ruling that investors have a legitimate claim to both principal and interest may have been unanticipated by even the SEC.

113 276 F.3d 187 (4th Cir. 2002) (holding that where a trial court does not find credible the factual basis of a relief defendant’s asserted legitimate claim — here, unverified testimony that the relief defendant had performed services in return for exorbitant payments and credit card charges — the court can disregard that claim and order disgorgement).

114 *Janvey v. Adams*, 588 F.3d 831, 834–35 (5th Cir. 2009). The court in oral arguments focused some of its attention on the fact that the SEC was opposed to Janvey’s pursuit of principal, whereas in *George* and *Kimberlynn Creek Ranch* the regulatory authority supported the actions. Transcript of Oral Argument, supra note 112, at 18–21. The court seemed to suggest that, if the SEC had wanted to pursue the investors as relief defendants, the receiver might have a stronger case. Such reasoning is, in my view, faulty and dangerous. It questions not whether the relief defendant falls under the definition of a relief defendant, but whether the plaintiff wants to pursue the person as a relief defendant. Thus, the reasoning places too much power in the hands of the regulatory agencies and gives insufficient weight to the actual definition that everyone agrees on.

115 This result might reasonably be adjusted downward to include only principal in other situations, particularly where investors do not hold certificates of deposit with a face value and specific interest amount. That is, where a person is an equity holder rather than a debt holder, a court might find that, in light of the risk and, perhaps, ownership rights, equity calls for finding a legitimate claim in the principal amount invested but not interest. Here, however, the Stanford investors held notes that created a contractual relationship with the bank, and both principal and investment amounts were covered under that contract.

116 588 F.3d at 834–35 (citations omitted).

117 *Id.* at 835 (*quoting CFTC v. Kimberlynn Creek Ranch*, 276 F.3d 187, 192 (4th Cir. 2002)).
118 Id. at n. 2 (“The George court did not indicate any intention to depart from the precedents on which it relied. The opinion does not cast any doubt upon our conclusion that the Investor Defendants here, against whom no wrongdoing has been alleged, have ownership interests in and legitimate claims to the proceeds of the CDs that they purchased from the Stanford Bank just as thousands of other innocent investors have done.”).

119 See, e.g., May, 2010 Survey — Federal Regulation of Securities, Annual Review of Federal Securities Regulation 65 Bus. Law. 923, 963 (“[I]t will be important to early investors in Ponzi schemes … for the courts to thrash out the criteria for determining when those early investors get to keep their money, and when they must give it back for placement in a pool from which they will then be paid only a pro rata share.”).

120 In re Independent Clearing House Co., 41 B.R. 985, 1005 n.20 (Bankr. Utah 1984), aff’d in part, rev’d in part, 77 B.R. 843, 855 & n.19 (D. Utah 1987) (holding that the bankruptcy court properly rejected the trustee’s attempt to avoid all transfers to the Ponzi scheme’s investors, since, “Even were we to find for the trustee on his first theory, the result here would not be equitable.”).

121 See Brief of Intervenor John J. Little, Court-Appointed Examiner at Appendices, Janvey v. Alguire, No. 09-10761 (5th Cir. Sept. 30, 2009).

122 For example, Phillip Preis, Esq., represented some 63 investors. Id. at ii.

123 Some relief defendants were added sooner than July. For example, many of the financial advisors were added on April 15. Receiver’s Complaint Naming Stanford Financial Group Advisors as Relief Defendants, SEC v. Stanford Int’l Bank, No. 3:09-cv-00298-N (N.D. Tex. Apr. 15, 2009).


125 See, e.g., Svea Herbst-Bayliss, Pershing Ready to Handle Stanford Requests, REUTERS, March 5, 2009, http://www.reuters.com/article/idUSTRE5247SL20090305 (some investors had been relying on their brokerage accounts and investment proceeds for such necessities as rent, groceries, and payroll); see also Transcript of Oral Argument, supra note 112, at 38–40 (description of how deeply the improper freeze was affecting, for example, retirees and pension funds).

129 Order, supra note 102.
130 This number is smaller than the 913 total relief defendants because some relief defendants did not have accounts with the brokerages to which Janvey had access.
132 Adams, 588 F.3d at 834.
135 See, e.g., Perdue v. Kenny, 130 S.Ct. 1662, 1673 (2010) (approving of Georgia’s lodestar method (including lodestar enhancements for particularly superior attorney performance), which compares fees in the area for similar services and uses various factors to determine reasonableness of fees, without requiring subjective analysis like that under the Johnson factors).
136 When considering whether a fee award is reasonable, Johnson v. Ga. Highway Express, Inc., 488 F.2d 714, 717–19 (5th Cir. 1974) sets out the twelve factors the court should consider: “(1) the time and labor involved; (2) the novelty and difficulty of the questions; (3) the skill requisite to perform the legal service properly; (4) the preclusion of other employment by the attorney due to the acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorneys; (10) the political ‘undesirability’ of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.”

*Id.*

The SEC and the examiner actually argued that the Receiver should receive nothing for work done during this time.


142 At least one court has explicitly considered and rejected the type of redistribution scheme addressed in *George*. In *SEC v. Byers*, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009), aff’d, No. 10-312-CV, 2010 WL 4185097 (2d Cir. Oct. 25, 2010) and aff’d sub nom. *SEC v. Malek*, No. 09-3583-CV, 2010 WL 4188029 (2d Cir. Oct. 25, 2010), the court agreed with the receiver that a *George*-like approach would be unwieldy and harmful: “[T]he Court could order investors to repay all the cash distributions they received from the Wextrust entities, and then the Receiver could make a distribution based on each investors’ actual investment. The practical problems associated with this approach, however, preclude it from being a viable option. Many of the investors may not have the money, and litigation to collect it would be expensive, time-consuming, and, in some instances, cruel.” (emphasis added). Janvey, facing an even more complicated and widespread fraud, should have followed this reasoning.