UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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| SECURITIES INVESTOR PROTECTION CORPORATION,<br><br>Plaintiff,<br><br>-v-<br><br>BERNARD L. MADOFF INVESTMENT SECURITIES LLC,<br><br>Defendant. | 12 MC 115 (JSR)<br><br>OPINION AND ORDER |
| In re:<br><br>MADOFF SECURITIES | |
| PERTAINS TO:<br><br>Consolidated proceedings on standing and SLUSA issues | |



JED S. RAKOFF, U.S.D.J.

In the complaints underlying the instant consolidated proceeding, Irving H. Picard (the "Trustee"), the trustee appointed under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa et seq., to administer the estate of Bernard L. Madoff Investment Securities LLC ("Madoff Securities"), has asserted common law claims, such as aiding and abetting fraud and unjust enrichment, against various "feeder fund" defendants described below. These defendants now seek to dismiss the Trustee's suits against them, arguing that the Trustee has no standing to bring these actions.

The Court assumes familiarity with the underlying facts of Madoff Securities' fraud and ensuing bankruptcy, and recounts here only those facts that are relevant to the instant issues. The defendants here seeking dismissal of the Trustee's complaints include principals and affiliates of the so-called "feeder funds," investment funds that pooled their customers' assets for investment with Madoff Securities. In essence, the Trustee alleges that these individuals and entities knew of Madoff Securities' fraud but looked the other way because they received substantial fees and other payments from Madoff Securities. The Trustee alleges that their actions (or inaction) allowed Madoff Securities' Ponzi scheme to continue and grow, thereby causing harm to those Madoff Securities' customers who were duped by the scheme. Based on these allegations, the Trustee seeks to recover from these third-party defendants such monies as he believes are owed to Madoff Securities' customers for distribution as part of the Madoff Securities liquidation.

Defendants have moved to dismiss the Trustee's complaints in their respective adversary proceedings, arguing that (1) the Trustee lacks standing to assert these common law claims, and (2) that, if the Trustee has standing to pursue these claims, the claims are precluded nonetheless by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), 15 U.S.C. § 78bb. Defendants previously moved to withdraw the reference to the Bankruptcy Court, and the Court granted that motion with respect to these two issues on a consolidated basis. Order at 4-5, No. 12 Misc. 115, ECF No. 114 (S.D.N.Y. Aug. 22, 2012). The Court also withdrew the reference on the issue of whether the "insider exception" to New York's doctrine of in pari delicto applies to the Trustee's claims brought against Deborah Madoff and Stephanie Mack, the wives of Madoff's two sons. See id. at 5. The Court received briefing on each of these issues from defendants, the Trustee, and the Securities Investor Protection Corporation ("SIPC"), and heard oral argument on October 15, 2012. This Opinion and Order addresses the relevant issues in turn and directs further proceedings upon return to the Bankruptcy Court.

As an initial matter, the Trustee previously raised in similar actions many of the arguments he advances in the instant proceeding. In Picard v. HSBC Bank PLC, 454 B.R. 25 (S.D.N.Y. 2011), this Court rejected those arguments and found that the Trustee lacked standing to assert common law claims against HSBC Bank and other third-party defendants, but the Trustee nonetheless reasserted these arguments in the instant proceeding, seeking either to have this Court reconsider them or to preserve them for possible appeal. However, in June 2013, after the instant matter had been fully briefed and argued, the Court of Appeals for the Second Circuit affirmed this Court's decision in HSBC as well as Judge McMahon's similar decision in Picard v. JPMorgan Chase & Co., 460 B.R. 84 (S.D.N.Y. 2011), and held that the Trustee lacks standing to assert common law claims on behalf of either Madoff Securities or its customers against alleged aiders-and-abettors of Madoff Securities' fraud. See Picard v. JP Morgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC.) ("JP Morgan II"), 721 F.3d 54 (2d Cir. 2013).

The decision of the Court of Appeals, as applied to the instant matter, disposes of many of the Trustee's arguments here. As the Court of Appeals noted, the Trustee's authority to bring actions such as the instant cases turns on the prudential rule of standing that "[a] party must 'assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties.' " JP Morgan II, 721 F.3d at 58 (quoting Warth v. Seldin, 422 U.S. 490, 499 (1975)). Thus, the first question in determining whether the Trustee may assert his desired claims is whether the Trustee may bring these claims on behalf of Madoff Securities itself. It is clear that he may not.

The doctrine of in pari delicto is a well-established principle of New York law based on the notion that "one wrongdoer may not recover against another." Id. at 63 (citing Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010)). In the bankruptcy context, "[t]he debtor's misconduct is imputed to the trustee because, innocent as he may be, he acts as the debtor's representative," id. at 63, and therefore the doctrine of in pari delicto "bars the Trustee (who stands in Madoff's shoes) from asserting claims directly against the Defendants on behalf of the estate for wrongdoing in which Madoff (to say the least) participated," id. at 58 (emphasis in original). See also Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) ("[A] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation."). To the extent that the Trustee has asserted in this proceeding various policy reasons why in pari delicto should not apply on the facts of this case, those arguments were rejected by the Second Circuit, and thus they are rejected here as well. See JPMorgan II, 721 F.3d at 64-65.

Without the authority to bring claims on behalf of Madoff Securities itself, the Trustee also argues that he is entitled to bring claims on behalf of Madoff Securities' customers. However, the "the implied prohibition in Article III against third-party standing applies to actions brought by bankruptcy trustees." Id. at 67; see also id. (citing Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416 (1972) for the proposition that "federal bankruptcy law does not empower a trustee to collect money owed to creditors"). Seeking to escape Caplin's prohibition against bankruptcy trustees asserting claims of the debtor's creditors, the Trustee argues that SIPA, rather than the Bankruptcy Code, provides for such standing. In doing so, the Trustee relies on three theories of standing: bailment, subrogation, and assignment. As described below, the Second Circuit (like this Court before it) rejected the Trustee's bailment and subrogation theories, holding that Caplin applies notwithstanding SIPA, and this Court adopts that conclusion.

In JPMorgan II, the Second Circuit rejected the Trustee's theory that he had standing to bring suit as a bailee of Madoff Securities' customer property, finding that SIPA "does not confer upon SIPA trustees a power, denied all other bankruptcy trustees, to sue third parties on claims that belong to persons other than the estate," as the statute nowhere references bailment "or in any way indicate[s] that the trustee is acting as bailee of customer property." See id. at 71-72. The Second Circuit likewise rejected the Trustee's attempt to draw upon common law principles of bailment for a variety of reasons that need not be repeated here. See id. at 72-73. Nor was the Second Circuit convinced by the Trustee's attempt to read into SEC Rule 15c3-3 the creation of a bailment relationship between a broker-dealer and his customers. See id. at 73 ("Whatever Rule 15c may do, it does not confer power on a SIPA trustee to sue on behalf of customers."). Thus, to the extent that the Trustee argues that he has standing as a bailee of customer property, those arguments are of no avail.

The Second Circuit next considered and rejected the Trustee's argument that SIPC has standing to bring common law claims (and SIPC, in turn, assigned that right to the Trustee) under a theory of equitable subrogation because SIPC advanced funds to pay Madoff Securities' customers' net-equity claims, pursuant to SIPA's mandate. See 15 U.S.C. § 78fff-3(a). The Second Circuit found that, by its terms, SIPA merely provides for "a narrow right of subrogation – for SIPC to assert claims against the fund of customer property and thereby recoup any funds advanced to customers once the SIPA trustee has satisfied those customers' net equity claims" – and that, if such a broader right of subrogation existed, the court would have expected such a right "to be manifested in the statutory wording and in the record." 721 F.3d at 74-75. Accordingly, this

Court rejects the Trustee's argument that he has standing to bring the instant claims under a subrogation theory for the reasons stated in JPMorgan II.[1]

However, while the Second Circuit rejected the Trustee's bailment and equitable-subrogation theories of standing, that court was not asked to consider whether the Trustee has standing to bring common law actions as an assignee of customer claims because, as recognized by this Court's decision in HSBC, the Trustee at that time had "received no assignments of customer claims against third parties."[2] 454 B.R. at 36-37. In the instant proceedings, the Trustee alleges that he has now received assignments of customers' claims against third parties in two contexts: First, he asserts that he has received assignments from various Madoff Securities customers as part of the settlement of those customers' proofs of claim filed

[1] To the extent that the Trustee seeks to rely on the Second Circuit's decisions in Redington v. Touche Ross & Co., 592 F.2d 617 (2d Cir. 1978), rev'd, 442 U.S. 560 (1979), and St. Paul Fire & Marine Insurance Co. v. PepsiCo, Inc., 884 F.2d 688 (2d Cir. 1989), the Court refers to the Second Circuit's clear and cogent discussion of why the Trustee's reliance on those precedents is unavailing. See JPMorgan II, 721 F.3d at 66-71.

[2] While this Court briefly addressed the question of the Trustee's standing as an assignee of customers' claims in HSBC, that issue was not squarely before the Court, both because, as noted above, the Trustee at that time had not received assignments of customer claims and because the Trustee raised the argument "only in a footnote in his brief." 454 B.R. at 36. Thus, the Court is free to reconsider its prior views based on the full presentation of the issue it has received both on the papers and at oral argument in this consolidated proceeding, and it declines to rest its decision on the discretionary doctrine of law of the case. See In re PCH Associates, 949 F.2d 585, 592 (2d Cir. 1991) (noting that law of the case "is a discretionary rule of practice and generally does not limit a court's power to reconsider an issue").

with the estate, see, e.g., Decl. of Andrew D.W. Cattell dated Aug. 3, 2012 ("Cattell Decl."), Ex. J; and, second, he alleges that he obtained assignments as one form of consideration in the settlement agreements reached and approved by the Bankruptcy Court with respect to the Trustee's claims against various Madoff Securities feeder funds, see, e.g., Cattell Decl. Ex. K.

As a general matter of New York law, "an assignee who holds legal title to an injured party's claim has constitutional standing to pursue the claim." Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., No. 08 Civ. 7508, 2012 WL 3584278, at *5 (S.D.N.Y. Aug. 17, 2012). Section 541(a)(7) of the Bankruptcy Code includes as property of the estate "[a]ny interest in property that the estate acquires after the commencement of the case." 11 U.S.C. § 541(a)(7). Thus, the Second Circuit has held, in the context of a non-SIPA bankruptcy, that "a trustee may assert claims assigned to it by a bankrupt's creditors for the benefit of the estate, because those claims can become property of the estate under § 541(a)(7)." In re CBI Holding Co., Inc., 529 F.3d 432, 459 (2d Cir. 2008).

The question then becomes whether there exists a conflict between SIPA and the Bankruptcy Code with respect to the Trustee's authority to accept assignments of creditor claims. See 15 U.S.C. § 78fff(b) (stating that a SIPA liquidation proceeding "shall be conducted in accordance with, and as though it were being conducted under" the Bankruptcy Code, but only "[t]o the extent consistent with the provisions of this chapter"). Defendants argue that the

Trustee is prevented from receiving these assignments by § 78fff-2(b) of SIPA, which provides:

> Any payment or delivery of property pursuant to this subsection may be conditioned upon the trustee requiring claimants to execute, in a form to be determined by the trustee, appropriate receipts, supporting affidavits, releases, and assignments, but shall be without prejudice to any right of a claimant to file formal proof of claim within the period specified in subsection (a)(3) of this section for any balance of securities or cash to which such claimant considers himself entitled.

15 U.S.C. § 78fff-2(b) (emphasis added). Based on this language, defendants argue that SIPA limits a trustee's power to obtain assignments to those obtained as a condition of payment of a customer's "net-equity" claim; that is, the Trustee may only receive by assignment that customer's net-equity claim, not the customer's claims against third parties. Thus, defendants contend that § 78fff-2(b) of SIPA conflicts with the broader assignment rights provided by § 541(a)(7) of the Bankruptcy Code, and therefore § 541(a)(7) must give way.

However, it is unlikely that Congress would couch a restriction on a SIPA trustee's authority to obtain assignments in the language of an affirmative grant of power. Section 78fff-2(b) deals with a type of payment to a certain class of creditors – net-equity claims paid to customers of a debtor-broker-dealer out of a separate customer property estate – that are not ordinarily part of a run-of-the-mill bankruptcy. Thus, viewing this provision as a grant of power, its language may be read to authorize the Trustee to set conditions on what otherwise would seem to be statutorily mandated payments of net-equity claims to customers. At no point does this provision expressly state that the Trustee has any less power with respect to assignments than an ordinary bankruptcy trustee, implying that Congress did not intend such a reading.

It must be noted that other courts in this district have held that SIPA bars a trustee from obtaining assignments of claims against third parties. See, e.g., Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 554-55 (S.D.N.Y. 1990); In re Park S. Sec., LLC., 326 B.R. 505, 515 (Bankr. S.D.N.Y. 2005). But these cases were decided before the Second Circuit's decision in CBI and thus rely on an assumption that a trustee has no authority to accept assignments absent express authorization in SIPA. However, because a SIPA trustee is "vested with the same powers . . . as a trustee in a case under title 11," 15 U.S.C. § 78fff-1(a), and because ordinary bankruptcy trustees, after CBI, have the authority to accept assignments of creditor claims against third parties, that assumption no longer holds true. Therefore, this Court is not persuaded by these contrary decisions.

Finally, this outcome also makes sense as a matter of the practical and policy concerns motivating the Second Circuit's rejection of the Trustee's subrogation theory in JPMorgan II. While the Trustee insisted that the defendants in those actions effectively would be immunized from suit if the Trustee were not authorized to bring customer claims, the JPMorgan II court noted that "it is not obvious why customers cannot bring their own suits against the Defendants," and, in fact, "customers had already filed such actions." 721 F.3d at 76. Here, by contrast, by assigning claims to the Trustee, the customers relinquished their right to bring suit; in this context, defendants — individuals and entities who, if one accepts the Trustee's allegations (as the Court must on a motion to dismiss), were complicit in Madoff Securities' fraud — would indeed be immunized from suit, at least those suits to be brought on behalf of the specific creditors who assigned their claims. Moreover, that the assigning creditors have fully relinquished their claims minimizes the specter of inconsistent judgments and divided control over lawsuits if claims could be pursued by the Trustee and customers simultaneously, see id. at 77, as the Trustee would exercise sole control over the assigned claims. Cf. CBI, 529 F.3d at 458 ("We can think of many arguments against allowing a trustee to usurp the claims of a bankrupt's non-cooperating creditors that do not counsel against permitting creditors to voluntarily transfer their claims to a trustee as part of a court-approved plan of reorganization or liquidation."). In sum, where nothing in § 78fff-2(b) explicitly restricts the Trustee's authority to obtain assignments under the Bankruptcy Code, and where such an assignment raises none of the concerns addressed in JPMorgan II, the Trustee has standing as an assignee of creditor claims to assert those creditors' common law causes of action against third-party defendants.[3]

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[3] The defendants briefly raise a question with respect to the

Having found that the Trustee has standing to bring validly assigned common law claims, the Court must turn to the second issue in this consolidated proceeding: whether the Trustee's pursuit of those claims is precluded by SLUSA. SLUSA provides that "[n]o covered class action based upon the statutory or common law of any State . . . may be maintained in any State or Federal court by any private party alleging[] a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). The relevant question for this consolidated proceeding is whether the Trustee's aggregation of claims through assignment constitutes a "covered class action" under SLUSA. For the reasons that follow, the Court finds that it does.

SLUSA includes within the definition of a covered class action "any single lawsuit in which . . . damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members." 15 U.S.C. § 78bb(f)(5)(B)(i). However, SLUSA also includes a "counting" provision, under which "a corporation, investment company, pension

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validity and enforceability of at least some of the assignments based on which the Trustee seeks to assert claims. As this question raises an issue of fact relevant only to some of the defendants who are party to this consolidated proceeding, it is an issue properly reserved for consideration upon return to the Bankruptcy Court. This Opinion and Order expresses no view as to these issues.

plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action." 15 U.S.C. § 78bb(f)(5)(D).

Defendants argue that SLUSA applies here because the Trustee's claims sound in fraud, relate to Madoff Securities' purported trading in covered securities, and are brought "on behalf of" the thousands of Madoff Securities customers from whom he claims to have received assignments.[4] The Trustee contends that SLUSA should not apply because he is entitled to the protections of SLUSA's counting provision, in that he is a single entity not created solely in order to bring these specific adversary proceedings, and thus his pursuit of the assigned claims should not be deemed a "covered class action."

Courts generally have held that bankruptcy trustees should be treated as a single entity under SLUSA in order to avoid undermining a trustee's ability under the Bankruptcy Code to pursue claims owned by the debtor. See LaSala v. Bordier et Cie, 519 F.3d 121, 136 (3d Cir. 2008) ("Giving effect to Congress's desire not to preempt claims that pass from a debtor corporation to its bankruptcy estate

[4] The Court declines to address whether the Trustee alleges in any given complaint "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). Such an inquiry must be made on a complaint-by-complaint basis, looking at, e.g., what conduct the Trustee alleges and each defendant's relationship to Madoff Securities' fraud. Accordingly, the Court declines to address this issue on a consolidated basis and addresses only whether the Trustee's pursuit of assigned customer claims constitutes a "covered class action."

is important because to do otherwise would work a significant change in the bankruptcy system that Congress created and, according to the legislative history cited above, intended to leave undisturbed."). Here, however, the Trustee is not attempting to pursue claims belonging to the debtor, a single entity, for the benefit of many; rather, he seeks to assert claims belonging to many creditors as a single entity. Thus, the Court must look through the Trustee's form to the source of the Trustee's claims in order to properly apply SLUSA on the facts of this case.

In LaSala v. Bordier et Cie, 519 F.3d 121, the Court of Appeals for the Third Circuit held that a claim assigned to a litigation trust for the benefit of the debtor's unsecured creditors was not precluded by SLUSA because the assignor of the claim was a single entity (the debtor). In so holding, the court looked to the language of 15 U.S.C. § 78bb(f)(5)(B)(i) and noted that the definition of "covered class action" is "two-pronged: to be a covered class action, (1) the claim must be brought 'on behalf of 50 or more persons,' and (2) questions of law or fact common to '<u>those persons</u>' must predominate." Bordier et Cie, 519 F.3d at 133 (emphasis in original). The court continued:

> Prong two of § 78bb(f)(5)(B)(i), then, seems to use the terms "persons" and "members of the prospective class" to refer to the original owners of the claim – those injured by the complained-of conduct, as those are the persons who might have common questions of law or fact related to the claim that predominate over individual questions of law or fact. Reading prong one in light of prong two, the phrase "on behalf of 50 or more persons" seems to refer to someone bringing a claim on behalf of 50 or more

> injured persons. In other words, the phrase refers to the assignors of a claim, not to the assignee (or, if the assignee is a trust, to its beneficiaries).

Id. at 134 (emphasis in original).

Although Bordier et Cie addressed a litigation trust separate from the bankruptcy trustee, the principles enunciated in that decision apply on the facts of this case as well. Here, the Trustee stands in the shoes of the assignors, not the bankruptcy estate, because, as discussed above, the Trustee could not bring these suits as the debtor's representative under the doctrine of in pari delicto. Questions of reliance, damages, and the like would be addressed to the thousands of customers and other creditors who assigned their claims to the Trustee, just as they would in a shareholder class action. Furthermore, as evidenced by the enumerated list in SLUSA's counting provision – which must inform the Court's understanding of the term "entity" that follows – the counting provision is intended to preserve the rights of preexisting entities, such as corporations and pension plans, to assert claims on their own behalf. See Bordier et Cie, 519 F.3d at 132-33 ("[T]he court is to follow the usual rule of not looking through an entity to its constituents unless the entity was established for the purpose of bringing the action, i.e., to circumvent SLUSA."). Broadening the definition of "entity" to encompass circumstances in which a representative asserts claims belonging to completely distinct entities and individuals stretches the term beyond Congress's intent.

Moreover, for purposes of the action here, the Trustee is in effect an entity "established for the purpose of participating in the action." Under Caplin, as discussed above, the duties of a bankruptcy trustee generally do not extend to bringing claims owned by creditors of the estate. See 406 U.S. at 428. Thus, in the context of pursuing these claims, the Trustee is acting in his role as assignee, and that role solely entails the litigation of these claims. Cf. Cape Ann Investors LLC v. Lepone, 296 F. Supp. 2d 4, 10 (D. Mass. 2003) (finding that the role of trustee of a litigation trust created as part of a bankruptcy proceeding "is no different than that of any shareholder class representative"). Where investors in Madoff Securities have sought to bring similar state-law class actions against similar defendants on their own, their claims have often been found to be precluded by SLUSA. See, e.g., Trezziova v. Kohn, 730 F.3d 112 (2d Cir. 2013) (holding that SLUSA applies to preclude a class action brought by investors in Madoff feeder funds asserting state-law claims against Madoff Securities' bankers). Allowing the Trustee to aggregate and assert such claims in such a way as to avoid SLUSA's prohibition against the original claimholders asserting the same claims is merely permitting the Trustee to make an end-run around SLUSA's limitations.[5] See Bordier et Cie, 519 F.3d at 136 ("[SLUSA's] statutory text and legislative

[5] This does not mean, of course, that the Trustee may assert no claims against the defendants to the proceedings here. SLUSA has no bearing on federal securities law claims, nor does SLUSA preclude common law claims brought on behalf of fifty or fewer persons.

history signal that the definition was designed to prevent securities-claims owners from bringing what are, in effect, class actions by assigning claims to a single entity."); RGH Liquidating Trust v. Deloitte & Touche LLP, 955 N.E.2d 329, 342 (N.Y. 2011) (Smith, J., dissenting) ("Nothing in either the language or the legislative history of SLUSA suggests that Congress meant to grant an exemption to any 'liquidation vehicle' that is doing precisely what SLUSA was enacted to prevent."). In light of the admonition that SLUSA must be given a "broad construction," Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 86 (2006), the Court finds that the Trustee is not entitled to the protections of SLUSA's counting provision, and thus his simultaneous pursuit of more than fifty customers' claims assigned to him is subject to SLUSA preclusion (assuming, of course, that his actions otherwise would be barred by SLUSA, see supra note 4).

Finally, the Court turns to the question of whether the "insider exception" to the doctrine of in pari delicto allows the Trustee to bring unjust enrichment claims against Stephanie Mack, the widow of Mark Madoff, and Deborah Madoff, the wife of Andrew Madoff. Although the in pari delicto doctrine generally bars the Trustee from bringing suit against Madoff Securities' co-wrongdoers, an exception to this rule exists for claims by the Trustee against corporate insiders for breaches of their fiduciary duties. See Global Crossing Estate Representative v. Winnick, No. 04 Civ. 2558, 2006 WL 2212776, at *15 (S.D.N.Y. Aug. 3, 2006); In re Granite

Partners, L.P., 194 B.R. 318, 332 (Bankr. S.D.N.Y. 1996) ("In pari delicto bars claims against third parties, but does not apply to corporate insiders or partners. Otherwise, a trustee could never sue the debtor's insiders on account of their own wrongdoing.").

The allegations relevant to this motion to dismiss are as follows: Mark Madoff, now deceased, and Andrew Madoff are Bernard Madoff's sons and former Co-Directors of Trading at Madoff Securities. Second Am. Compl. ("SAC") ¶¶ 8, 11, Picard v. Peter B. Madoff, Adv. Pro. No. 09-01503, ECF No. 113 (Bankr. S.D.N.Y. filed May 4, 2012). Stephanie Mack was married to Mark Madoff from October 2004 until his death in December 2010, id. ¶ 10, and Deborah and Andrew Madoff were married in January 1992, id. ¶ 12. The Trustee alleges that Mark and Andrew, because of their involvement in Madoff Securities, improperly "received, directly or indirectly, substantial transfers of Customer Property from [Madoff Securities] which properly belonged to the company and, ultimately, its customers." Id. ¶ 67. With respect to Stephanie and Deborah, the Trustee brings common law claims of unjust enrichment, id. ¶¶ 213-18, alleging that they received or benefited from "at least $54,548,463 in transfers, and interests in property of undetermined value, . . . during the Statutory Period and resulting from their marriages to Mark and Andrew Madoff." Id. ¶ 128. The Trustee further alleges that many of these transfers were jointly made directly from Madoff Securities' primary account to Stephanie and Mark or Deborah and Andrew during the course of their marriages. See id. Exs. H, K.

For the purposes of this motion, it is uncontested that Andrew and Mark were corporate insiders of Madoff Securities but that Deborah and Stephanie were not themselves insiders or even Madoff Securities employees, nor is there any allegation that either Deborah or Stephanie personally had knowledge of Madoff Securities' wrongdoing. Rather, the Trustee argues that the insider exception should be extended as a matter of equity to cover Deborah and Stephanie in order to prevent corporate insiders from circumventing liability for breaches of their fiduciary duties by asserting a shared property interest with their spouses. Effectively, the Trustee seeks to extend the definition of insiders to include spouses solely by virtue of their marriage to, and their receiving of joint transfers with, corporate insiders. This novel proposition is unsupported by any legal authority and extends the limited insider exception beyond its proper bounds.

As a general rule, the New York Court of Appeals has stated that "the principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said the defense applies even in difficult cases and should not be 'weakened by exceptions.' " Kirschner, 938 N.E.2d at 950 (quoting McConnell v. Commonwealth Pictures Corp., 7 N.Y.2d 465, 470 (1960)). Applying this logic, the Second Circuit has read the insider exception to the in pari delicto doctrine narrowly to allow only for suits by a bankruptcy trustee against a fiduciary of the debtor corporation, not against third parties who are alleged to have aided and abetted the debtor's fraud, short of control by the third party over the debtor. See In re Mediators, Inc., 105 F.3d 822, 826 (2d Cir. 1997) (denying standing to creditors' committee as representative of the debtor under in pari delicto where a law firm had assisted the debtor's sole shareholder in stripping the debtor corporation of assets); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094-95 (2d Cir. 1995) (rejecting the claim that an accounting firm exercised "total domination and control" over the debtor and finding that the insider exception did not apply). The parties acknowledge that no exception to in pari delicto has thus far been carved out in these circumstances by any court, and this Court declines to create a new exception and thereby circumvent Kirschner's instruction. As a matter of logic, it would make little sense that those who engaged in culpable conduct would receive more favorable treatment under the insider exception than a spouse who is not alleged to have had any role in the fraud. Cf. Kirschner, 938 N.E.2d at 950 ("The justice of the in pari delicto rule is most obvious where a willful wrongdoer is suing someone who is alleged to be merely negligent.").

The Trustee interposes many arguments against the application of in pari delicto in this context.[6] First, the Trustee argues that

[6] In his brief, the Trustee implies that the Court's consideration of this issue is improper because the issue has already been determined by the Bankruptcy Court. The Court disagrees. Judge Lifland granted the Trustee's motion to amend his complaint to add these common law claims against Stephanie and Deborah and found that the issue of whether in pari delicto applies "to be one of first impression, [such that] it is not clear from the face of the pleadings that the amendment would be futile." Picard v. Madoff, 468 B.R. 620, 633

the Court should focus on the transfers themselves — which were made to both an insider (Mark or Andrew) and an outsider (Stephanie or Deborah) — and suggests that the spouses should not be permitted to assert equitable defenses that are unavailable to their co-transferees. However, this approach misses the point of the equitable doctrine of in pari delicto, which seeks to determine the relationship between the parties to a given suit in deciding whether to adjudicate a dispute between wrongdoers. See Kirschner, 938 N.E.2d at 950 ("[N]o court should be required to serve as paymaster of the wages of crime, or referee between thieves." (quoting Stone v. Freeman, 298 N.Y. 268, 271 (1948))). The purpose of the insider exception is to hold fiduciaries responsible for their conduct as control persons; whether Deborah or Stephanie received the transfers in conjunction with their husbands is irrelevant to the question of whether they exercised control over the company. Indeed, it is uncontested that the spouses themselves were in no way involved in Madoff Securities' fraud.[7]

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(Bankr. S.D.N.Y. 2012). Here, however, the defendants have now moved to dismiss the Trustee's complaint against them, see Notice of Motion to Dismiss, No. 12 Misc. 115, ECF No. 270 (S.D.N.Y. filed Aug. 3, 2012), and so the Court is considering a separate motion to be judged on a different standard than that previously applied by the Bankruptcy Court.

[7] The Trustee also argues that it is improper for the Court to decide whether the insider exception applies on a motion to dismiss and should instead await discovery in this action. However, there is no factual dispute as to Stephanie and Deborah's lack of involvement at Madoff Securities. See SAC ¶¶ 8, 10 (conclusorily alleging that Stephanie and Deborah were insiders while making no allegations that they had any role at Madoff Securities). Thus, this issue may

The Trustee also seeks to analogize the circumstances here to SEC v. Cavanagh, 155 F.3d 129 (2d Cir. 1998), in which the Second Circuit upheld the grant of a preliminary injunction for possible disgorgement by the Securities and Exchange Commission ("SEC"), which froze assets placed by a husband in his wife's bank account. In Cavanagh, the Second Circuit stated that allowing the wife "to now claim valid ownership of those proceeds would allow almost any defendant to circumvent the SEC's power to recapture fraud proceeds, by the simple procedure of giving stock to friends and relatives." Id. at 137. However, the statutory right of the SEC, as a regulatory entity, to seek disgorgement of ill-gotten gains is a different matter entirely from the Trustee's assertion of standing to bring common law claims in order to claim additional funds on behalf of a bankruptcy estate. Thus, Cavanagh has no bearing on this case.

Finally, it bears mention that the Trustee has other avenues through which he might seek to recover these funds, and thus the Court does not feel compelled as a matter of equity to create a new exception to the in pari delicto doctrine in these circumstances. For example, the Trustee may assert claims for breach of fiduciary duty and unjust enrichment against the insiders themselves, as he has done here, see SAC ¶¶ 206-18, and he may bring fraudulent-conveyance and preferential-transfer claims against both the insiders and their spouses. The fact that strategic errors on the

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properly be determined on the pleadings as a matter of law. Cf. Mediators, 105 F.3d at 824 (deciding this issue on a motion to dismiss).

part of the Trustee may prevent him from bringing such recovery proceedings against Deborah and Stephanie here, see Picard v. Madoff, 468 B.R. 620 (Bankr. S.D.N.Y. 2012), does not provide a sufficient reason to expand the limited insider exception to cover new categories of non-culpable individuals. Accordingly, in pari delicto applies, and the Trustee's common law claims against Stephanie Mack and Deborah Madoff are dismissed for lack of standing.

In sum, the Court finds that the Trustee has standing to bring claims on behalf of Madoff Securities' customers to the extent, but only to the extent, that the customers validly assigned their claims to the Trustee. However, the Court also finds that the Trustee's pursuit of these assigned claims, to the extent that he brings the claims of more than fifty assignors, constitutes a covered class action for purposes of SLUSA. Whether SLUSA applies to bar these claims because the Trustee alleges "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," 15 U.S.C. § 78bb(f)(1)(A), in a given action is a matter to be determined by the Bankruptcy Court upon remand. Finally, the Trustee's common law claims against Stephanie Mack and Deborah Madoff are dismissed for lack of standing under the doctrine of in pari delicto. Except to the extent provided in other orders, the Court directs that the adversary proceedings listed in Exhibit A of item number 114 on the docket of 12 Misc. 115 be returned to the

Bankruptcy Court for further proceedings consistent with this Opinion and Order.

SO ORDERED.

Dated: New York, NY
December 5, 2013

JED S. RAKOFF, U.S.D.J.

# Florence County
# Twelfth Judicial Circuit
# Public Index



Switch View

## Gilbert Jarrell , plaintiff, et al VS Malinda Schurlknight , defendant, et al

| | | | | | |
|---|---|---|---|---|---|
| Case Number: | 2013CP2101483 | Court Agency: | Common Pleas Court | Filed Date: | 06/03/2013 |
| Case Type: | Common Pleas | Case Sub Type: | Person Inj/Other 399 | File Type: | Jury |
| Status: | Dismissed | Assigned Judge: | James, George C Jr | | |
| Disposition: | Dismissed by Court - not Rule 40J | Disposition Date: | 03/07/2014 | Disposition Judge: | James, George C Jr |
| Original Source Doc: | | Original Case #: | | Restore Reason: | Reopened Case |
| Judgment Number: | | Court Roster: | | | |

Case Parties Judgments Tax Map Information Associated Cases Actions Financials

Click the icon to show associated parties.

| Name | Address | Race | Sex | Year Of Birth | Party Type | Party Status | Last Updated |
|---|---|---|---|---|---|---|---|
| Aubrey Owens As The Personal Representative | | | | | Plaintiff | | 07/03/2013 |
| Bennett, Jerry | | | | | Plaintiff | | 06/06/2013 |
| Beth A Long As Executrix | | | | | Plaintiff | | 06/06/2013 |
| Bloom, Michael | | | | | Plaintiff | | 06/06/2013 |
| Bullard, April | | | | | Plaintiff | | 07/03/2013 |
| Citizens Bank(Inactive) | | | | | Defendant | | 08/14/2013 |
| Douglas, James | | | | | Plaintiff | | 07/03/2013 |
| Eagleton, Vincent | | | | | Plaintiff | | 07/03/2013 |
| Ervin, Markell | | | | | Plaintiff | | 06/06/2013 |
| Estate Of Bernice Ratley Steadman | | | | | Plaintiff | | 07/03/2013 |
| Estate Of Colon Owens | | | | | Plaintiff | | 07/03/2013 |
| Estate Of Frederick Lawrence Irwin | | | | | Plaintiff | | 06/06/2013 |
| Graham, Sheila | | | | | Plaintiff | | 06/06/2013 |
| Hoffman, Brian | | | | | Plaintiff | | 06/06/2013 |
| Huntley, Christopher | | | | | Plaintiff | | 06/06/2013 |
| Hurst, Steven | | | | | Plaintiff | | 06/06/2013 |
| Irwin, Frederick Lawrence | | | | | Plaintiff | | 06/06/2013 |
| Irwin, Gary | | | | | Plaintiff | | 06/06/2013 |
| Irwin, Mary Lou | | | | | Plaintiff | | 06/06/2013 |
| Irwin, Rose Mary | | | | | Plaintiff | | 06/06/2013 |
| Jacobs, Fran | | | | | Plaintiff | | 07/03/2013 |
| Jarrell, Gilbert | | | | | Plaintiff | | 09/02/2014 |
| Johnson, Jimmy | | | | | Plaintiff | | 07/03/2013 |
| Josey, Jon Rene | PO Box 5478 Florence SC 295025478 | | | | Defendant Attorney | | 07/08/2013 |
| Justice, Arthur E. Jr. | PO Box 5478 Florence SC 29502 | | | | Defendant Attorney | | 11/07/2013 |
| Lay, John Thomas | 1201 Main St., Ste. 1200 Columbia SC 29201 | | | | Defendant Attorney | | 02/18/2014 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Locklear, Brenda Annette Ford | | | | | Plaintiff | | 07/03/2013 |
| Long, Beth A | | | | | Plaintiff | | 06/06/2013 |
| Monti, Joe | | | | | Plaintiff | | 06/06/2013 |
| Monti, Robin | | | | | Plaintiff | | 06/06/2013 |
| Muldrow, Leatisha | | | | | Plaintiff | | 07/03/2013 |
| Nettles, E. LeRoy Sr. (Inactive) | PO Box 699 Lake City SC 29560 | | | | Defendant Attorney | | 08/14/2013 |
| Owens, April | | | | | Plaintiff | | 06/06/2013 |
| Owens, Aubrey | | | | | Plaintiff | | 07/03/2013 |
| Owens Colon | | | | | Plaintiff | | 07/03/2013 |
| Penny, Crystal | | | | | Plaintiff | | 07/03/2013 |
| Pipkins, Katina | | | | | Plaintiff | | 07/03/2013 |
| Pruitt, Karen | | | | | Plaintiff | | 06/06/2013 |
| Ratley, Rudolph | | | | | Plaintiff | | 07/03/2013 |
| Reassure America | | | | | Trust Account Payee | | 03/13/2014 |
| Roller, Steven | | | | | Plaintiff | | 06/06/2013 |
| Rudolph Ratley As The Personal Representative | | | | | Plaintiff | | 07/03/2013 |
| Schurlknight, Laura | | | | | Defendant | | 06/06/2013 |
| Schurlknight, Lee I | | | | | Defendant | | 06/06/2013 |
| Schurlknight, Malinda | | | | | Defendant | | 07/05/2013 |
| Sharp, Brittany | | | | | Plaintiff | | 06/06/2013 |
| Sims, Lana Hancock IV | PO Box 2285 Columbia SC 29202 | | | | Defendant Attorney | | 11/07/2013 |
| Steadman, Bernice Ratley | | | | | Plaintiff | | 07/03/2013 |
| Teal, Jonathan | | | | | Plaintiff | | 06/06/2013 |
| Teal, Stacie | | | | | Plaintiff | | 06/06/2013 |
| Twombley, James Ashley | 311 Carteret St. Beaufort SC 29902 | | | | Plaintiff Attorney | | 06/03/2013 |
| Williams, Jonathan | | | | | Plaintiff | | 07/03/2013 |
| Williams, Nicole | | | | | Plaintiff | | 06/06/2013 |
| Young, Bobby | | | | | Plaintiff | | 07/03/2013 |

at 833, 114 S.Ct. 1970. District courts should remain cognizant of the common law adage that the "public ... [is] required to care for the prisoner, who cannot by reason of the deprivation of his liberty, care for himself." *Estelle,* 429 U.S. at 103–04, 97 S.Ct. 285.

[42, 43] Thus far, our analysis has focused on the considerations district courts should take into account when determining whether to recruit counsel at the initial pleadings stage. Those considerations change as a case progresses to discovery or trial. Taking depositions, conducting witness examinations, applying the rules of evidence, and making opening statements are beyond the ability of most pro se litigants to successfully carry out. *See Santiago,* 599 F.3d at 763–64; *Henderson,* 755 F.3d at 567. These tasks are even more challenging in cases, like Perez's, where complex medical evidence (including expert testimony) is needed to assess the adequacy of the treatment received. *See e.g., Greeno,* 414 F.3d at 658; *Santiago,* 599 F.3d at 761. District courts abuse their discretion where they fail to consider the complexities of advanced-stage litigation activities and whether a litigant is capable of handling them. *Id.* Our cases would thus suggest that Perez should likely be granted pro bono counsel upon remand, once his case moves beyond the pleadings stage.

[44] We emphasize, however, that counsel is critical at all stages of litigation. For this reason, courts should strive to implement programs to help locate pro bono assistance for indigent litigants. *See Henderson,* 755 F.3d at 563 (describing the Trial Bar Pro Bono Program instituted by the United States District Court for the Northern District of Illinois).

## III. CONCLUSION

The judgment of the district court is Reversed, and this case is Remanded for further proceedings consistent with this opinion.

**Ronald R. PETERSON, as Trustee for the estates of Lancelot Investors Fund, Ltd., et al., Plaintiff–Appellant,**

v.

**McGLADREY LLP, et al., Defendants–Appellees.**

**No. 14–1986.**

United States Court of Appeals, Seventh Circuit.

Argued April 16, 2015.

Decided July 7, 2015.

Rehearing and Rehearing En Banc* Denied Aug. 6, 2015.

**Background:** Chapter 7 trustee for estates of bankrupt mutual funds brought action against funds' auditor and affiliated entities, alleging that auditor was negligent in failing to discover that purported factors in which funds invested were actually Ponzi schemes. The United States District Court for the Northern District of Illinois, Elaine E. Bucklo, J., 2010 WL 4435543, dismissed complaint, and trustee appealed. The Court of Appeals, 676 F.3d 594, vacated and remanded. On remand, the United States District Court for the Northern District of Illinois, Elaine E. Bucklo, J., dismissed complaint, and trustee appealed.

* Judge Flaum and Judge Rovner did not participate in the consideration of this petition.

**Holding:** The Court of Appeals, Easterbrook, Circuit Judge, held that doctrine of pari delicto barred trustee's claims against auditor.

Affirmed.

1. **Action** ⟾4

**Contribution** ⟾5(5)

Under Illinois law, wrongdoer cannot recover compensation from third party who may have made things worse or missed chance to avert loss.

2. **Action** ⟾4

Under Illinois law, in pari delicto defense applies not only when two litigants have committed same wrong, but also when one fails to mitigate consequences of the other's wrong.

3. **Action** ⟾4

Under Illinois law, doctrine of pari delicto barred claims by trustee of mutual funds' bankruptcy estate against auditor for negligently failing to discover that purported factors in which funds invested were actually Ponzi schemes, even though auditor's alleged errors were distinct from fund manager's false representations to investors, where funds' representations and auditors's errors led to same loss.

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Steven M. Farina, Colleen McNamara, Joseph M. Terry, Katherine M. Turner, Jessica L. Pahl, Williams & Connolly LLP, Washington, DC, Marcus D. Fruchter, Attorney, Schopf & Weiss LLP, Chicago, IL, for Defendants–Appellees.

Clark Steven Tomashefsky, Stein Ray LLP, Chicago, IL, for Plaintiff–Appellant.

Before BAUER, EASTERBROOK, and SYKES, Circuit Judges.

EASTERBROOK, Circuit Judge.

Gregory Bell established five mutual funds ("the Funds"), raised about $2.5 billion, and invested most of the money in vehicles managed by Thomas Petters, who said that he was financing Costco's consumer-electronics inventory. Instead he was running a Ponzi scheme, which collapsed in September 2008. Both Bell and Petters have been sent to prison for fraud (Bell threw in his lot with Petters in 2008). Ronald Peterson was appointed as the Funds' trustee in bankruptcy to conserve what assets remained and recover additional assets from solvent parties who may have borne some of the fault.

Trustee Peterson has filed multiple suits, which have led to three decisions (so far) by this court. *Peterson v. McGladrey & Pullen, LLP,* 676 F.3d 594 (7th Cir. 2012) *(McGladrey I); Peterson v. Somers Dublin Ltd.,* 729 F.3d 741 (7th Cir.2013); *Peterson v. Winston & Strawn LLP,* 729 F.3d 750 (7th Cir.2013). The current appeal is *McGladrey II.*

McGladrey & Pullen (now known as McGladrey LLP) was one of the Funds' auditors. (There are other defendants; we use McGladrey as the example to simplify the exposition.) It did not perform the sort of spot checks that would have revealed that Petters had no business other than recycling investors' funds while skimming some off. Trustee Peterson contends that McGladrey is liable to the Funds under Illinois law for accounting malpractice; McGladrey insists that, if it is culpable, so are the Funds, and that the doctrine of *in pari delicto* blocks liability. We explained in *McGladrey I* that this doctrine rests on "the idea that, when the plaintiff is as culpable as the defendant, if not more so, the law will let the losses rest where they fell." 676 F.3d at 596. See also *Pinter v. Dahl,* 486 U.S. 622, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988).

We held three things in *McGladrey I:* (i) that McGladrey cannot be liable to the Funds for failing to detect and reveal what Bell himself knew; (ii) that at this stage of the litigation Bell cannot be charged with knowing about Petters's fraud in 2006 and 2007, just because he joined it in 2008; and (iii) that federal bankruptcy law does not supersede a state-law *in pari delicto* defense. We remanded so that the district court could resolve McGladrey's defense after developing a factual record about the state of Bell's knowledge in 2006 and 2007.

Back in the district court, McGladrey took a new tack. Instead of trying to show that Bell was in on Petters's scam before 2008, McGladrey contended that Bell had committed a fraud of his own. The documents that the Funds sent to potential investors represented that the money the Funds lent to the Petters entities was secured by Costco's inventory and that repayment would be ensured by a "lockbox" arrangement under which Costco would make its payments into accounts that the Funds (rather than Petters) would control. Bell has admitted that this is not how the arrangement worked, and that he knew this from the outset. The money in the accounts came, not from Costco, but from a Petters entity known as PCI. This meant that the Funds had no assurance that Costco was the source of the money placed in the lockbox accounts, and no assurance that Petters would continue paying. Indeed, it was materially misleading to use the word "lockbox," which in commercial factoring is understood as a device to ensure that third parties do not intercept the merchant's payments. Yet, Bell concedes, he caused the Funds to lie to actual and potential investors, thinking (no doubt correctly) that they would feel more secure if they believed that money came directly from Costco and that repayment was outside Petters's control.

The district court concluded that the Funds' misconduct (the documents were issued in the Funds' names and are their responsibility, see *Janus Capital Group, Inc. v. First Derivative Traders,* — U.S. —, 131 S.Ct. 2296, 180 L.Ed.2d 166 (2011)) was at least equal in gravity to McGladrey's, if not a greater fault—for the Trustee does not accuse McGladrey of fraud. What's more, the court concluded, the Funds' representations and McGladrey's errors (if any) led to the same loss: investors' money went down a rabbit hole. Either truth by the Funds (leading to smaller investments), or McGladrey's discovery of Petters's scam, would have protected the investors from loss during 2006 and 2007, when the Funds were growing rapidly. This led the court to dismiss the suit against McGladrey and the other defendants under the *in pari delicto* doctrine, without considering whether McGladrey had failed to perform its duties. *Peterson v. General Electric Co.,* 2014 U.S. Dist. LEXIS 48688 (N.D.Ill. Apr. 8, 2014).

Trustee Peterson concedes that Bell and the Funds made false statements to prospective investors (though the Trustee denies that the falsity amounts to fraud). But he insists that the *pari delicto* doctrine in Illinois applies only when the plaintiff and the defendant commit the *same* misconduct. If they commit different misconduct that contributes to a single loss then, according to the Trustee, the *pari delicto* doctrine drops out.

The Trustee does not refer to any case in Illinois stating such a principle, however. He has found, and quotes, lots of language saying that the doctrine applies when two parties commit or abet a single wrong—see, e.g., *Vine St. Clinic v. HealthLink, Inc.,* 222 Ill.2d 276, 297, 305 Ill.Dec. 617, 856 N.E.2d 422 (2006) ("the law will not aid either party to an illegal act, but will leave them without remedy as against each other")—but he has not found any decision holding or even saying in *dictum* that it applies *only when* two parties participate in a single wrong.

[1] As far as we can tell, Illinois regularly disallows litigation between one wrongdoer (here, Bell and the Funds) and another (here, McGladrey) whose acts may have added to the loss or failed to reduce it. See, e.g., *Gerill Corp. v. Jack L. Hargrove Builders, Inc.*, 128 Ill.2d 179, 206, 131 Ill.Dec. 155, 538 N.E.2d 530 (1989); *Neuman v. Chicago*, 110 Ill.App.3d 907, 910, 66 Ill.Dec. 700, 443 N.E.2d 626 (1982); *Wanack v. Michels*, 215 Ill. 87, 94–95, 74 N.E. 84 (1905). These decisions involve contribution or equitable apportionment and do not use the phrase "*in pari delicto*," but they conclude that a wrongdoer cannot recover compensation from a third party who may have made things worse or missed a chance to avert the loss. Other decisions in Illinois take the same view through still other language. See *Mettes v. Quinn*, 89 Ill.App.3d 77, 44 Ill.Dec. 427, 411 N.E.2d 549 (1980) (client cannot recover from attorney for attorney's advice to commit fraud, when harm to plaintiff was the result of her own fraud); *Robins v. Lasky*, 123 Ill.App.3d 194, 78 Ill.Dec. 655, 462 N.E.2d 774 (1984) (client cannot recover from attorney for advice to establish residence outside of Illinois to avoid service of process).

The Supreme Court summed up the *pari delicto* doctrine as comprising two principles: "first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306, 105 S.Ct. 2622, 86 L.Ed.2d 215 (1985) (footnote omitted). Both principles apply to a claim by the Funds, which raised money via deceit, against an auditor that negligently failed to detect a different person's fraud. (The Trustee is litigating on behalf of the Funds and is subject to all defenses McGladrey has against the Funds.)

[2] All ways of looking at the subject lead to the same conclusion. The Trustee has not found any Illinois case saying that the *in pari delicto* defense applies only when the two litigants have committed the same wrong, as opposed to one failing to mitigate the consequences of the other's wrong. And the Trustee has not found any case in Illinois recognizing liability under this situation, no matter what name applies.

[3] Foreclosing all liability when two parties commit distinct wrongs might seem to allow the failure of one safeguard to knock out others. Corporate and securities law rely on both managers and accountants to protect investors' interests. There would be a major gap in those bodies of law if, when one turns out to be a scamp, then the other is excused from performing his own duties, and investors are left unprotected. But that's not the outcome of applying the *pari delicto* doctrine to the Trustee's suit. The Trustee stepped into the shoes of the Funds, not the shoes of the investors. People who put up money have their own claims.

Claims against Bell may not be worth much (he's in prison), and securities-law claims against the Funds for misstatements in the offering documents aren't worth much either (they're bankrupt), but a claim against McGladrey may offer some recompense, if the auditor was indeed negligent or wilfully blind. See 225 ILCS 450/30.1(2); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 837–38 (7th Cir.2007) (Illinois law); *Kopka v. Kamensky & Rubenstein*, 354 Ill.App.3d 930, 935, 290 Ill.Dec. 407, 821 N.E.2d 719 (2004); *Builders Bank v. Barry Finkel & Associates*, 339 Ill.App.3d 1, 7, 273 Ill.Dec. 888, 790 N.E.2d 30 (2003). Proceedings on the investors' claims have been stayed pending resolution of the Trustee's suit. It is time to bring the investors' claims to the fore.

AFFIRMED

**Ronald R. PETERSON, as Trustee for the estate of Lancelot Investors Fund, Ltd., Plaintiff–Appellant,**

v.

**KATTEN MUCHIN ROSENMAN LLP, Defendant–Appellee.**

**No. 14–3632.**

United States Court of Appeals, Seventh Circuit.

Argued April 16, 2015.

Decided July 7, 2015.

**Background:** Trustee of bankruptcy estates of insolvent investor funds, each of which had made loans secured by nonexistent security to individual who supposedly used those loans to purchase inventory for other businesses, but who was actually operating massive Ponzi scheme, brought cause of action against law firm which acted as transactions counsel for funds in connection with these loan transactions. The United States District Court for the Northern District of Illinois, Harry D. Leinenweber, J., granted law firm's motion to dismiss, and trustee appealed.

**Holding:** The Court of Appeals, Easterbrook, Circuit Judge, held that allegations in trustee's complaint stated legal malpractice claim that was plausible on its face.

Reversed and remanded.

**1. Attorney and Client ⚷109**

Allegations in complaint filed by trustee of bankruptcy estates of insolvent investor funds, each of which had made loans secured by nonexistent security to individual who supposedly used those loans to purchase inventory for other businesses, but who was actually operating massive Ponzi scheme, that law firm which acted as transactions counsel for funds in connection with these loans had failed to properly advise funds on risks associated with manner in which these loan transactions were structured, without requiring direct lockbox deposits by business whose inventory they supposedly financed, and while prohibiting funds from having any direct contact with business, stated legal malpractice claim that was plausible on its face.

**2. Attorney and Client ⚷106**

One function of transactions lawyer is to counsel client how different legal structures carry different levels of risk, and then to draft and negotiate contracts that protect client's interests.

**3. Attorney and Client ⚷106**

Advising clients how best to maintain security for their loans using legal devices is vital part of a transactions lawyer's job.

**4. Attorney and Client ⚷106**

Transactions lawyer's task is to propose, draft and negotiate contractual arrangements that carry out a client's business objective, not to tell the client to have a different objective or to do business with different counterparty; however, within scope of his or her engagement, transactions lawyer must tell client what different legal forms are available to carry out client's business, and how, if at all, the risks of that business differ with the different legal forms.

laws is to control fraud. If the existence of fraud meant that an instrument were not a "security", then the main federal means to deal with financial fraud would vanish. Section 741(7) of the Bankruptcy Code provides that a "securities contract" is a contract for the purchase or sale of a security, and § 101(49)(A)(ii) says that security includes stock. The definition in § 101(49) comes almost verbatim from the Securities Act of 1933 and the Securities Exchange Act of 1934. No one doubts that shares of stock issued by crooked mutual funds or hedge funds are "securities" for the purpose of the 1933 and 1934 Acts. They are "securities" for the purpose of § 546(e) as well.

Other arguments need not be discussed in light of our conclusion that § 546(e) defeats the Trustee's actions. The judgments of the bankruptcy court are affirmed.

**Ronald R. PETERSON, as Trustee for the estates of Lancelot Investors Fund, Ltd., and Colossus Capital Fund, Ltd., Plaintiff–Appellant,**

v.

**WINSTON & STRAWN LLP, Defendant–Appellee.**

**No. 12–3512.**

United States Court of Appeals, Seventh Circuit.

Argued April 8, 2013.

Decided Sept. 6, 2013.

Rehearing and Rehearing En Banc* Denied Oct. 7, 2013.

**Background:** Chapter 7 trustee for estates of bankrupt mutual funds brought action against funds' law firm, alleging legal malpractice. The United States District Court for the Northern District of Illinois, Matthew F. Kennelly, J., dismissed suit.

**Holdings:** The Court of Appeals, Easterbrook, Chief Judge, held that:

(1) in pari delicto doctrine applied to preclude malpractice claims, and

(2) failure to alert funds' directors of corporate manager's questionable actions did not constitute legal malpractice.

Affirmed.

**1. Action 🔑4**

**Attorney and Client 🔑109**

**Bankruptcy 🔑2154.1**

Under Illinois law, in pari delicto doctrine applied to preclude malpractice claim by trustee for estates of bankrupt mutual funds against funds' law firm on the theory that factual representations in a circular sent to investors were false, where funds had represented the information to be true.

**2. Attorney and Client 🔑109**

Under Illinois law, failure by law firm for debtor mutual funds to alert funds' directors of corporate manager's questionable actions did not constitute legal malpractice, even if such conduct violated professional responsibility rule. Ill.Rules of Prof.Conduct, Rule 1.13.

**3. Action 🔑4**

**Attorney and Client 🔑109**

**Bankruptcy 🔑2154.1**

Under Illinois law, in pari delicto doctrine applied to preclude malpractice claim by trustee for estates of bankrupt mutual funds against funds' law firm on the theory that law firm failed to inform funds' di-

* Judge Flaum and Judge Rovner did not participate in the consideration of this petition.

rectors of corporate manager's questionable actions, absent allegation that alerting directors would have made any difference.

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Edward T. Joyce, Attorney, Edward T. Joyce & Associates, P.C., Clark Steven Tomashefsky, Attorney, Stein Ray LLP, Chicago, IL, for Appellant.

Christopher Landau, Attorney, Kirkland & Ellis LLP, Washington, DC, for Appellee.

Before EASTERBROOK, Chief Judge, and POSNER and SYKES, Circuit Judges.

EASTERBROOK, Chief Judge.

Ever since Gregory Bell's mutual funds, known as the Lancelot or Colossus group (collectively "the Funds"), folded in late 2008, their trustee in bankruptcy has been seeking assets from solvent third parties. Last year we considered the Trustee's claims against the Funds' auditor. *Peterson v. McGladrey & Pullen, LLP,* 676 F.3d 594 (7th Cir.2012). This appeal concerns the Trustee's claim, on behalf of two Funds, against one of their law firms. Other appeals, also decided today, arise from avoidance actions against some of the investors.

The Funds invested most of their money in ventures run by Thomas Petters, who claimed to be operating as a commercial factor—that is, a lender financing other businesses' inventory. A factor advances money to purchase inventory, takes a security interest in the inventory, and is repaid as the inventory is sold. The Funds' offering circulars told their investors that the Funds would verify the inventory's existence and ensure that repayments were made to a "lockbox"—that is, made directly to financial institutions that would ensure the money's proper application.

The Funds did not keep these promises and could not do so, because Petters was running a Ponzi scheme in which new investments were used to pay off older investments rather than to finance an operational business. Petters has been convicted of fraud. *United States v. Petters,* 663 F.3d 375 (8th Cir.2011). Bell concedes that he learned of, and joined, Petters's scam early in 2008; Bell pleaded guilty to fraud. But both Bell and the Funds' Trustee maintain that until 2008 Bell was ignorant of the Ponzi scheme. The events in question concern years during which, we must assume (because this suit was resolved on the pleadings), Bell honestly if incompetently thought Petters's businesses legitimate.

The Funds hired Winston & Strawn in 2005 to revise their offering circular (the "Confidential Information Memorandum") shown to persons thinking about investing in the Funds. According to the Trustee's complaint, Bell told the law firm that Petters refused to allow the Funds to verify the existence of inventory and that repayments did not come through lockboxes. The law firm prepared a revised offering circular, which the Funds started using in 2006; this circular, like the 2003 version, represents that the Funds will verify the existence of inventory and ensure that factors use lockboxes. The Trustee contends that the law firm committed malpractice, but the district court, invoking the doctrine of *in pari delicto,* dismissed the suit after concluding that Bell's knowledge was at least as great as the law firm's. 2012 WL 4892758, 2012 U.S. Dist. LEXIS 147653 (N.D.Ill. Oct. 10, 2012).

The Trustee has no greater rights against the law firm than the Funds themselves had, and the law firm maintains that the Funds had none because Bell (and thus the Funds) knew as much as the law firm did about Petters's activities. One potential problem with this perspective is that people and corporations often hire law firms for advice about what to do. Suppose we take it as established that Bell had learned of Petters's scheme by 2005. He and the Funds might well have needed to know what should happen next. If a law firm gave incompetent advice, it could not defend by asserting that Bell already knew the facts. The fault would not be equal, because Bell would have hired the law firm for legal expertise rather than factual information. Similarly, if Bell had been indicted for securities fraud and supplied a law firm with facts showing that the prosecution was untimely, and the law firm failed to invoke the statute of limitations, it could not defend a malpractice suit by observing that Bell knew all the facts. When the goal of hiring a professional adviser is to cope with the consequences of known facts, the parties' equal access to the facts is beside the point.

Nonetheless, the Trustee's complaint was properly dismissed, because it does not plausibly allege that the law firm violated any duty to the Funds. The Trustee does not contend that Winston & Strawn should have provided better, or even different, legal advice. Instead he contends that it should have done two things on learning that Petters would not allow verification of inventory and did not use a lockbox: The law firm should have alerted the Funds' directors and should have revealed the truth in the 2006 offering circular.

[1] The latter step would not have offered a benefit to the Funds (as opposed to their investors); to the contrary, it probably would have precipitated the Funds' immediate collapse. The Trustee has stepped into the shoes of the Funds, *not* of their investors, who may (or may not) have independent claims based on the contents of the 2006 circular. Lancelot Investors Fund and Lancelot Investment Management (of which Bell was the sole principal) issued that circular and thus vouched for the truth of the statements it contained. Winston & Strawn did not sign the document or warrant the truth of its contents. Cf. *Janus Capital Group, Inc. v. First Derivative Traders*, — U.S. —, 131 S.Ct. 2296, 180 L.Ed.2d 166 (2011) (discussing who is responsible for statements in documents used to sell securities). As administrator of the Funds' estate, the Trustee is in no position to collect from the law firm on the theory that factual representations in the 2006 circular were false, when the Funds represented them to be true.

[2] As for the Trustee's assertion that the law firm should have alerted the Funds' directors, the initial problem is that the law firm was not hired to blow the whistle on Bell, and the Trustee does not identify any rule of Illinois law (which governs here) treating failure to do so as a tort. The SEC's rules sometimes require disclosure or "noisy withdrawal," but the Funds were established in the Cayman Islands, and the Trustee does not contend that federal law governs the law firm's responsibilities. Rule 1.13 of the Illinois Rules of Professional Responsibility, which does apply (because the law firm rendered its services in Illinois), sometimes requires a lawyer to report to the highest corporate authority—which may well have been Bell, but we'll assume that the board is a higher authority. And we can assume, without deciding, that Rule 1.13 required the law firm to do more than it did. The problem for the Trustee is that no court in Illinois has held that failure to report a corporate manager's acts to the board of directors exposes a law firm to damages for malpractice. Rules of professional conduct

are enforced through the disciplinary mechanism rather than by awards of damages. The Trustee does not argue otherwise.

[3] Nor does the complaint plausibly allege that alerting the directors would have made a difference. The offering circular says that the four directors appointed Bell's firm, Lancelot Investment Management, to be responsible for conducting all of the Funds' investment-management operations. Thus Bell was as firmly in charge of the Funds as he was of his advisory firm—and we said exactly that in *McGladrey & Pullen* when holding that anything Bell knew, the Funds knew. 676 F.3d at 596. *McGladrey & Pullen* rejects the Trustee's argument that Bell's knowledge should not be imputed to the Funds because he was acting adversely to their interests. *Id.* at 599. The Trustee repeats that argument, which fares no better the second time.

One of the four directors lived in Hong Kong and the other three in the Bahamas. Nothing in the complaint suggests that any of the four ever exercised any responsibility over the Funds other than to delegate all powers and duties to Bell. The Trustee might have bolstered his claim by conducting an investigation into the four directors' careers and learning how they had responded if or when other firms with which they were affiliated had encountered troubled investments or balky borrowers (Petters's ventures fit both descriptions). But the Trustee conceded at oral argument that he had not conducted any prefiling investigation, and he did not ask for discovery in order to learn whether the directors were independent of Bell in any realistic sense.

That is equally true with respect to the "loan acquisition officer," a position that the 2006 circular said would be created. The Trustee does not know whether the job was filled—or, if it was, what the incumbent learned from Bell or Petters—and seems remarkably uncurious about those subjects. This makes it hard to advance a plausible claim that the law firm had a duty to bypass Bell and present the facts about Petters to the "loan acquisition officer."

The complaint and briefs stop with the assertion that the directors had a legal duty to ride herd on Bell and thus would have done so. That may be a correct statement of their duties, but the Trustee has not offered anything to make plausible a contention that the directors would have fulfilled them, even if the law firm had a duty to bypass Bell. Given the plausibility standard added to federal pleading law by *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007), and *Ashcroft v. Iqbal,* 556 U.S. 662, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009), this complaint was properly dismissed.

AFFIRMED.

**UNITED STATES of America, Plaintiff–Appellee,**

v.

**Christopher L. SPEARS, Defendant–Appellant.**

**No. 11–1683.**

United States Court of Appeals, Seventh Circuit.

Argued April 16, 2013.

Decided Sept. 6, 2013.

**Background:** Defendant was convicted in the United States District Court for the

Taft/

# The Crime-Fraud Exception to the Attorney-Client Privilege: Application and Ethical Considerations

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## ABSTRACT

The attorney-client privilege is a fundamental concept in the American justice system and was established to allow open and transparent discussions between attorney and client. Such transparency allows attorneys to facilitate a complete and effective defense of their client.[1] However, the attorney-client privilege is not absolute.[2] In fact, courts have carved out a plethora of waivers and exceptions, including the crime-fraud exception.[3] The crime-fraud exception has procedural and ethical considerations of which every attorney—whether in criminal or civil law—should be aware.

## INTRODUCTION

The crime-fraud exception is implicated when an attorney provides advice that promotes the occurrence or continuation of misconduct.[4] In complex areas of law with heavy attorney involvement, such as securities and bankruptcy, prosecutors have sometimes used the exception to their advantage in situations where legality of a client's conduct is at least questionable.[5] The mere allegation of a crime in these complex areas of law can vitiate the attorney-client privilege because many courts will conduct an *in camera* review of privileged material upon merely a prima facie showing that an attorney's involvement in a crime "has some foundation in fact."[6] Furthermore, through the use of a subpoena or search warrant, an attorney may be forced to become a witness or provide information against his/her own client.[7]

Accordingly, this handout will first discuss the basics of the attorney-client privilege and other ways in which the privilege can be waived. This discussion is followed by an explanation of the crime-fraud exception, ways in which prosecutors use the exception, and ethical considerations for attorneys when counseling clients on issues that may implicate the exception.

## DISCUSSION

### I. Attorney-Client Privilege

Many attorneys assume that the attorney-client privilege is a shield that is rarely pierced, but disclosure of confidential information is frequently compelled.[8] A common saying by courts and scholars is that the attorney-client privilege should be "strictly construed lest the secrecy thwart the search for truth."[9] Because the need for full disclosure—which is essential to an attorney's ability to effectively defend a client—conflicts with the court's public policy objective to seek the truth, variations of the following test have been used to determine whether the attorney-client privilege exists: (1) the communication must be confidential; (2) the communication must be to a lawyer or a representative of the lawyer; and (3) the communication must have been made in an effort to receive legal advice.[10] Furthermore, the privilege must be asserted, and the party seeking the protection of the privilege must prove the aforementioned elements and that the privilege has not been waived.[11]

The heavy burden of proving attorney-client privilege is illustrated in the following example: four creditors filed an involuntary petition for relief against a company under Chapter 7 of the United States Bankruptcy Code. The trustee of the company's bankruptcy estate subpoenaed an employee with a significant leadership role at the company and requested various communications and documents between the employee and the company's attorneys. The employee asserted attorney-client privilege and included a privilege log with the following information for each privileged document as evidence that the privilege applied: date, description, author, addressee(s), other recipients, privilege claimed, and pages.[12]

However, the "description" of each document in the privilege log was merely a one to two word description (e.g., "email"). The trustee filed a Motion to Compel Production of Documents Claimed as Privileged and argued that the employee was unable to carry his burden of proving that the documents were privileged. The court ruled in favor of the trustee and indicated that, without more, the employee's privilege log "amount[ed] to superficial invocations of the privilege."[13] The court affirmed that the party asserting the attorney-client privilege bears the burden to prove privilege on each and every privileged document and must also prove that the privilege was not waived. A party seeking the protection of privilege can use third party witnesses, affidavits, or a privilege log that clearly describes the reasoning for the privilege—"and [does] so in a manner that, without revealing information itself privileged or protected, will enable other parties to assess the claim."[14]

The above example illustrates the heavy burden that lies with the party claiming the attorney-client privilege. A thorough privilege log allows a party to prove documents are privileged, and that privilege has not been waived, at the outset. Furthermore, because an attorney's goal is to be an effective advocate for their client, attorneys should understand the different ways in which privilege can be waived—otherwise, a client may be less forthcoming if concerned that the privilege may be waived.

## II. General Waivers

The attorney-client privilege is fragile and may be unintentionally waived in a variety of ways including: (1) inadvertent or voluntarily disclosure to a third party;[15] and (2) a client's failure to object to privileged information being sought.[16] Imagine a potential client claims workplace discrimination and harassment. The client contacts her attorney via email and transmits relevant facts regarding the employer's alleged abuse. After the attorney and client exchange multiple emails, the attorney discovers that the client sent these emails while using an employer-issued computer. This scenario is unfortunately common, and courts have held that those emails are no longer protected by the attorney-client privilege.[17]

### A. *Inadvertent and Voluntary Disclosure*

The attorney-client privilege may be waived when otherwise privileged information is completely or partially disclosed to third parties—regardless of whether the disclosure was voluntary or inadvertent. In one case, a court even determined that voluntary disclosure of partial information waived privilege to the entire subject matter of that information.[18] Voluntary disclosure waived privilege in the following situations:

- where documents were provided to a government agency in the process of an investigation,[19]

- where a press release mentioned certain aspects of legal advice regarding the validity of a patent,[20]
- where counsel temporarily allowed opposing counsel to read a privileged letter during settlement discussions.[21]

Along with understanding that voluntary or inadvertent disclosure may waive privilege as to those documents disclosed, an attorney should also be aware that that the disclosure of one document, that seemingly does not matter, can trigger a waiver as to other or all related privileged documents.[22]

Inadvertent disclosures can occur in a wide variety of situations, but mostly in the discovery process, which highlights the importance of entering into confidentiality agreements or obtaining protective orders that guarantee the return of inadvertently disclosed privileged materials.[23] Courts take varying approaches to determining whether an inadvertent disclosure waives the privilege for the document or information disclosed. However, the most widely used test is the balancing test.[24] The balancing test was articulated by the Sixth Circuit in the following manner: "(1) the reasonableness of the precautions taken to prevent inadvertent disclosure in view of the extent of the document production, (2) the number of inadvertent disclosures, (3) the extent of the disclosure, (4) the promptness of measures taken to rectify the disclosure, and (5) whether the overriding interests of justice would or would not be served by relieving the party of its error."[25] This test allows courts to consider the circumstances of each case individually, but also means that rulings on inadvertent disclosure are unpredictable. For example, at least one court found that documents containing privileged conversations that were inadvertently produced with other non-privileged conversations during discovery was not a waiver because appropriate steps to prevent disclosure had been taken;[26] whereas another court found waiver of privileged materials where the privileged and non-privileged materials were co-located in one box and preventing disclosure through a thorough review would not have been arduous.[27]

B. *Failure to Object to Privileged Material Sought*

Some courts view a failure to object on grounds of attorney-client privilege in a deposition, request for production of documents, or during testimony as waiver.[28] This is particularly significant in the corporate context. A corporate executive's failure to assert the attorney-client privilege during a deposition when opposing counsel sought the substance of attorney-client conversations was held to be a waiver of the privilege. It follows that when a corporation's attorney fails to intervene to stop such questioning of his or her client and assert attorney-client privilege, waiver can occur.[29] This same concept can be applied in the reverse situation—e.g., a court may find the attorney-client privilege has been waived when a client does not object to his/her attorney testifying about certain privileged communications.[30] Thus, attorneys should be aware of the possibility that failure to object, in the first instance, to questions seeking confidential information can result in waiver and also inform clients as to this concept.

C. *Corporate Context*

A major issue of concern regarding the attorney-client privilege is who can waive the attorney-client privilege in the corporate context. The majority of case law points to the management of the corporation as being solely responsible for waiving the privilege,[31] and "when control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well."[32] Furthermore, when a situation arises in which it is unclear whether a corporate manager communicated with an attorney in her role as a corporation officer or as an individual, courts will usually determine that the privilege belongs to the corporation when the communications were regarding corporate matters.[33] It follows that employees may not be able to keep all of their privileged communications regarding the corporation confidential, because the corporation may waive the privilege as it deems necessary.

However, if an individual corporate employee is able to show that the corporation's attorney was consulted for the purpose of obtaining advice on individual liability and not corporate matters, some courts will rule that the privilege belongs to the individual.[34] In these cases, the individual asserting the privilege must establish five factors—called the Bevill Factors.[35] The fifth Bevill factor—which says the individual must show that the conversation was not within the corporation's concerns—is usually the most difficult to meet, but some courts will find the factor to have been met if the individual can show that the purpose of the communications was strictly for advice on individual liability.[36]

III. <u>The Crime-Fraud Exception</u>

Although the burden is on the claimant to prove that the attorney-client privilege exists and that associated materials are protected, a party seeking otherwise privileged information via the crime-fraud exception has the burden of showing that advice or other communications were provided to further a crime.[37] It follows that the crime-fraud exception can be articulated in the following manner: (1) a prima facie showing that, when the client requested legal advice, the client was involved in illegal activity and was planning such activity at the time the legal advice was sought, or such illegal activity was completed following legal advice; and (2) the legal advice was sought to assist with the facilitation or concealment of the crime.[38] In this regard, the attorney's knowledge that advice is sought to facilitate a crime is irrelevant; instead, it is the client's intent that is dispositive.[39] However, the crime-fraud exception does not apply to advice sought to deal with past criminal actions. Instead, only a current crime or the planning of a future crime triggers the crime-fraud exception.[40]

The party invoking the crime-fraud exception must show that the attorney's advice was used to carry out the crime. This burden can be accomplished in the following ways: (1) the party can use non-privileged material to prove a crime is occurring or being planned; or (2) some courts allow a prima facie showing of unlawful activity through *in camera* review of privileged documents.[41] However, the moving party must provide "a showing of a factual basis adequate to support a good faith belief by a reasonable person that *in camera* review of the materials may reveal evidence to establish the claim that the crime-fraud exception applies."[42] Although concepts similar to the crime-fraud exception have been applied since the 18th century, its application has significantly increased in recent years—especially in the corporate environment[43]—and has procedural and ethical considerations.

A. *Application of the Crime-Fraud Exception*

Due to an increase in government regulation of corporations, criminal prosecutors are increasingly invoking the crime-fraud exception to compel disclosure of attorney-client discussions.[44] In these situations, the government has the burden of proof and is required to provide the court more than simple suspicions about a potential crime to invoke an *in camera* review of documents.[45] Usually a prima facie case must be made or—as one court described it—a "modest evidentiary threshold should be crossed"[46] before an *in camera* review of attorney-client communications is conducted. Although no precise agreement as to the definition of "prima facie" exists, one analysis by the Ninth Circuit indicates that a prima facie case can be achieved with just "good faith statements by the prosecutor" and that the party asserting attorney-client privilege may not always be provided an opportunity to counter the government's evidence.[47]

B. *Government Issuance of a Subpoena*

In *United States v. Zolin*, the court declared that independent evidence of a crime was not the only way to vitiate the attorney-client privilege.[48] Instead, prosecutors are able to use the information the government was seeking in the *in camera* review to prove the crime-fraud exception. Essentially, a low threshold to achieve *in camera* review allows prosecutors more leverage to challenge and defeat assertions of attorney-client privilege through the crime-fraud exception.[49] The process for vitiating the attorney-client privilege in this context usually begins by the government issuing a subpoena to the attorney.[50]

Although prosecutors' use of the crime-fraud exception to vitiate the attorney-client privilege has increased in federal criminal investigations and prosecutions, the United States Attorney's Manual does recognize the importance of the attorney-client privilege and the implications of serving a subpoena on an attorney—especially a subpoena seeking information regarding relationships with a client.[51] In this regard, the Manual requires that such subpoenas must be approved by an Assistant Attorney General or Deputy Assistant Attorney General. Furthermore, the Manual states "personnel must strike a balance between an individual's right to the effective assistance of counsel and the public's interest in the fair administration of justice and effective law enforcement . . . all reasonable attempts shall be made to obtain the information from alternative sources before issuing the subpoena to the attorney, unless such efforts would compromise the investigation or case."[52] However, as previously mentioned, in practice, the use of subpoenas to attorneys based on the crime-fraud exception is prevalent.[53]

Government subpoenas invoking the crime-fraud exception should demand information related only to those communications or materials relevant to the alleged crime. Many scholars believe that, if a subpoena goes beyond this scope, an attorney has an ethical obligation to attempt to prevent the prosecutor from vitiating the attorney-client privilege—usually through a motion to quash. Unfortunately, in the grand jury context, the prosecutor will sometimes be allowed to respond to the motion to quash on an ex parte basis—and because the secrecy of a grand jury investigation is deemed greater than the public policy of attorney-client privilege—attorneys may only have a small chance to defeat the prosecutor's opposition to the motion.[54]

C. *Example of the Process*

In *United States v. Under Seal* (In re Grand Jury Proceedings), the government issued a subpoena to a company's attorney based on an investigation of the company's billing practices.[55] After withholding documents the attorney claimed were protected by the attorney-client privilege, the government filed a motion to compel and provided an *in camera* submission consisting of testimony and documents for support. A U.S. district court granted the government's motion to compel the production of the documents to the grand jury based on the government's argument that the crime-fraud exception vitiated the privilege. However, the company's attorneys were never provided an opportunity to counter the government's *in camera* submission.

On appeal, the company argued that the procedure that the lower court used—specifically disallowing the company an opportunity to rebut the government's *in camera* submission—was a violation of due process. The Fourth Circuit, citing *In re Grand Jury Subpoena,*[56] rejected this argument. The court stated, "the government has the right to preserve the secrecy of its submission because it pertains to an on-going investigation."[57]

Because the government has the ability to vitiate attorney-client privilege without rebuttal in some cases, it is important for attorneys to understand the circumstances where attorney-client communications can be revealed, or in which the attorney could be forced to testify against his/her client. An understanding of the intersection between the crime-fraud exception and attorney-client privilege will allow an attorney to prepare for the possibility of being forced to testify against a client or preferably to prevent it. Furthermore, certain ethical considerations are implicated if an attorney receives a subpoena to testify. In this regard, an attorney should be aware of the jurisdiction's adoption of the ABA Model Rules of Professional Conduct and other professional or ethical rules applicable and generally be cognizant of the type of clients he/she represents.[58]

D. *Search Warrants*

Another way that the government may attain attorney-client privileged information is through a warrant to search and seize materials from a law office—providing a unique intersection between attorney-client privilege and the Fourth Amendment. This situation is troubling because materials that are within the scope of the warrant and privileged documents unrelated to the warrant might be seized and reviewed during the investigation.[59] For example, in *United States v. Skeddle*, the defendants argued that investigators' review of privileged material was improper because an independent judicial officer was not appointed to conduct the review—instead the government's supposedly independent "taint team" reviewed the documents. After the "taint team" reviewed eleven boxes of alleged attorney-client privileged information found in a search of an attorney's office, the court held, "[a]ssuming that the defendants . . . should have been heard before the documents were disclosed to the government, failure to give them that opportunity . . . does not require exclusion of all the seized materials. The appropriate response is . . . an opportunity to be heard, on a document-by-document basis . . . ."[60] Unfortunately, decisions similar to *Skeddle* may impact clients' willingness to reveal confidential information—thus impeding the effectiveness of counsel and the purpose of the attorney-client privilege.

Because of the recognized importance of the attorney-client privilege, the Department of Justice through its U.S. Attorneys Manual provides for various internal safeguards to the accidental seizure of privileged information unrelated to a warrant.[61] However, even with these safeguards, the possibility of unrelated privileged communications being intercepted in a government's investigation can have a damaging effect on an attorney's effectiveness in representing his/her client. Clients with knowledge that their communications with an attorney could be legally seized—even if inadmissible in court—are likely to withhold critical information from their attorneys because of the remote possibility that their communications can be used against them in the future.[62] Safeguards or not, the damage is done.

One way in which attorneys can prevent certain privileged information seized in a search from being seen by the government is to aggressively seek an independent third party judicial review of documents seized—such as a special master or judicial officer.[63] The U.S. Attorneys Manual requires the consideration of this type of independent review before approving a warrant to search a law building.[64] However, the Manual only requires prosecutors to consider the independent review; in many cases the government will conduct the search and review of seized materials using its own "privilege team" or "taint team"—which is supposed to consist of individuals with no involvement in the case at hand so as not to taint the investigation.

The following five steps should be taken by an attorney in the event the government executes a search warrant at a law office or corporate facility with attorney-client information: (1) immediately contact the supervising government official by phone; (2) assert the attorney-client privilege and demand that the government cease their search; (3) advise the supervising official of the existence of privileged information belonging to parties unrelated to the warrant and the likelihood of the infringement on those parties' privilege; (4) follow up in writing via fax or email to the official with your assertion and demand; and (5) consider filing an injunction.[65] Although not all encompassing, these steps are a solid framework for ensuring that a client's rights have been asserted during a search.

### E. *Ethical Considerations*

The Third Circuit has described attorneys' obligation to maintain a client's secrets in the following way: "the canons of ethics make the attorney's common law obligation to maintain the secrecy of his communications with his client a professional mandate."[66] However, the court has also said that such "seal of secrecy" is broken when the client elicits or seeks advice in furtherance of a crime.[67] Because prosecutors are increasingly using the crime-fraud exception as justification for ignoring the privilege, and many courts are willing to allow prosecutors *in camera* review after only a minimal showing, an attorney's duty of confidentiality, professional obligations, and the application of the crime-fraud exception seem to conflict. In some situations, failure to report certain actions of a client can result in disciplinary action by a jurisdiction's highest court, as well.[68]

For the aforementioned reasons, it is important for an attorney to be aware of his/her jurisdiction's adoption of the ABA Model Rules—which every state except California has adopted in some form.[69] For example, the Model Rules state that a "lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal."[70] However attorneys may find it difficult to determine whether a client is requesting advice for unlawful activity. In blurry situations, an attorney should first determine the seriousness of the unlawful conduct and engage in an in depth inquiry. Based on the results of an attorney's own investigation into the matter, the seriousness of those results, and resources (such as the ABA Model Rules and case law), the attorney may need to consider advising the client to cease certain activities, the attorney may need to withdraw from representation, or the attorney may even need to disclose certain communications.[71] Furthermore, if an attorney receives a grand jury subpoena, the attorney may want to consider retaining his/her own attorney before approaching the topic with his/her client as conflicting interests may exist between the attorney and the client.[72]

In *United States v. Cavin*, the Fifth Circuit provided a lengthy discussion of the ethical considerations that attorneys face when dealing with a client that is using legal advice to commit a crime.[73] The court stated that "[t]he black-letter rule is that the lawyer must disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by the rule against revealing client confidences."[74] Furthermore, in *United States v. DeLucca*, a case in which an attorney was present at a meeting where alleged criminals discussed an illegal scheme, the court convicted the attorney and determined that "[i]f he did not intend to take part in the conspiracy, he had a duty, as an attorney, to report the matter to the proper parties and tell the members of the conspiracy that he wanted to withdraw."[75] Thus, an attorney must be able to balance the above considerations with being a strong advocate for her client and understand the differences between furthering illegal conduct, advising a client regarding past unlawful activity, and defending against false accusations.

## CONCLUSION

Understanding the crime-fraud exception to the attorney-client privilege is vital in order for an attorney to properly defend a client's right to be open and honest—which allows attorneys to provide better counsel. Prosecutors can often be zealous and may seek to use the crime-fraud exception to gather evidence when no such crime is occurring. An understanding of a jurisdiction's case law on the crime-fraud exception can allow attorneys to fiercely oppose the prosecution's ability to meet their required burden of producing prima facie evidence of a crime. However, it is important for an attorney to also recognize that the legal profession requires certain ethical obligations to report criminal activities of a client.

Endnotes

*Ralph Kohnen is a partner at Taft Stettinius & Hollister and Chair of its Corporate Compliance and White Collar Criminal Practice Group, and Ryan Burandt is a 2016 Summer Associate at Taft.

[1] *See* Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).

[2] *See* Clark v. United States, 289 U.S. 1, 15 (1933).

[3] *See* 3 Jack B. Weinstein & Margaret A. Berger, *Weinstein's Federal Evidence*, § 503.03 (Mark S. Brodin, ed., Matthew Bender 2d ed. 2015).

[4] *See* Automated Sols. Corp. v. Paragon Data Sys., 756 F.3d 504, 517 (6th Cir. 2014) (citing In re Grand Jury Subpoenas, 454 F.3d 511, 519 (6th Cir. 2006).

[5] Earl Silbert, *The Crime-Fraud Exception to the Attorney-Client Privilege and Work Product Doctrine, the Lawyer's Obligations to Disclosure, and the Lawyer's Response to Accusation of Wrongful Conduct*, 23 Am. Crim. L. Rev. 351, 351 (1986).

[6] Motley v. Marathon Oil Co., 71 F.3d 1547, 1551 (10th Cir. 1995) (citing In re Grand Jury Proceedings, Vargas, 723 F.2d 1461, 1467 (10th Cir. 1983).

[7] H. Lowell Brown, *The Crime-Fraud Exception to the Attorney-Client Privilege in the Context of Corporate Counseling*, 87 Ky. L.J. 1191, 1197 n.12 (1999).

[8] *See* 1 EDNA SELAN EPSTEIN, THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE, 3 (5th ed. 2007).

[9] EPSTEIN, *supra* note 8, at 11.

[10] *See* In re Royce Homes, LP, 449 B.R. 709, 723 (Bankr. S.D. Tex. 2011).

[11] *See id.* at 723-725.

[12] *See id.* at 714-718.

[13] *Id.* at 727.

[14] *Id.* (citing Rule 26 (b) (5) of the Federal Rules of Civil Procedure).

[15] *See* Fosbre v. Las Vegas Sands Corp., 2016 U.S. Dist. LEXIS 5422, at 5; Denney v. Jenkins & Gilchrist, 362 F. Supp. 2d 407, 416 (S.D.N.Y. 2004).

[16] *See* Liang v. AWG Remarketing, Inc., No. 2:14-cv-0099, 2015 U.S. Dist. LEXIS 168139, at 17-18 (S.D. Ohio Dec. 15, 2015).

[17] *See e.g.,* Holmes v. Petrovich Dev. Co., LLC, 119 Cal. Rptr. 3d 878, 882-893 (Ct. App. 2011); In re Reserve Fund Secs. & Derivative Litig. v. Reserve Mgmt. Co., 275 F.R.D. 154 (S.D.N.Y. 2011) (holding marital privilege waived in regards to emails sent over employer's computer); *but see* Fishman v. Swarthout, No. 2:13-cv-02421-GGH, 2015 U.S. Dist. LEXIS 38679 (E.D. Cal. Mar. 25, 2015) (holding privilege only waived if employer made compute r policy known to employees).

[18] *See* Murray v. Gemplus Int'l, S.A., 217 F.R.D. 362, 365-367 (E.D. Pa. 2003).

[19] *See* Westinghouse Elec. Corp. v. Republic of Phil., 951 F.2d 1414, 1420 (3d Cir. 1991) (noting circuit split over whether disclosure in unrelated government investigation waives privilege to only government or all third parties).

[20] *See* Electro Scientific Indus. V. Gen. Scanning, Inc., 175 F.R.D. 539, 543 (N.D. Cal. 1997).

[21] *See* Eagle Compressors, Inc. v. HEC Liquidating Corp., 206 F.R.D. 474, 476-477 (N.D. Ill. 2002).

[22] *See* EPSTEIN, *supra* note 8, at 584-586.

[23] *See* EPSTEIN, *supra* note 8 at 433.

[24] *See* EPSTEIN, *supra* note 8 at 442-443.

[25] Nilavar v. Mercy Health Sys., No. 3:99cv612, 2004 U.S. Dist. LEXIS 30531, at 10-11 (S.D. Ohio Mar. 22, 2004).

[26] *See* Lois Sportswear, U.S.A., Inc. v. Levi Strauss & Co., 104 F.R.D. 103, 105 (S.D.N.Y. 1985).

[27] *See* Liggett Group, Inc. v. Brown & Williamson Tobacco Corp., 116 F.R.D 205, 208 (M.D.N.C. 1986).

[28] *See* Liang v. AWG Remarketing, Inc., No. 2:14-cv-0099, 2015 U.S. Dist. LEXIS 168139 at 17-23 (S.D. Ohio Dec. 15, 2015); *See also* Nguyen v. Excel Corp., 197 F.3d 200, 206 (5th Cir. 1999).

[29] *See* Nguyen v. Excel Corp., 197 F.3d at 206.

[30] *See* Drimmer v. Appelton, 628 F. Supp. 1249, 1251 (S.D.N.Y. 1986); *See also* United States v. Aronoff, 466 F. Supp. 855, 862 n.7 (S.D.N.Y. 1979) (holding attorney can waive privilege on behalf of client).

[31] *See* EPSTEIN, *supra* note 8 at 28.

[32] EPSTEIN, *supra* note 8 at 28 (quoting Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 349 & n.5 (1985).

[33] *See* EPSTEIN, *supra* note 8 at 155.

[34] *See* EPSTEIN, *supra* note 9 at 157 (citing In re Bevill, Bresler & Schulman Asset Mgmt. Corp., 805 F.2d 120, 125 (3d Cir. 1986)).

[35] The court in *Bevill* affirmed the district court's application of the following five factors—which are now referred to as the Bevill factors: "First, they must show they approached [counsel] for the purposeof seeking legal advice. Second, they must demonstrate that when they approached [counsel] they made it clear that they were seeking legal advice in their individual rather than in their representative capacities. Third, they must demonstrate that the [counsel] saw fit to communicate with them in their individual capacities, knowing that a possible conflict could arise. Fourth, they must prove that their conversations with [counsel] were confidential. And, fifth, they must show that the substance of their conversations with [counsel] did not concern matters within the company or the general affairs of the company."

[36] *See* In re Grand Jury Proceedings, 156 F.3d 1038, 1041-1042 (10th Cir. 1998).

[37] David J. Fried, *Too High a Price for Truth: The Exception to the Attorney-Client Privilege for Contemplated Crimes and Frauds*, 64 N.C. L. REV. 443, 461-462 (1986).

[38] *See* EPSTEIN, *supra* note 8, at 670 (citing In re Grand Jury Investigation (Schroeder), 842 F.2d 1223, 1226 (11th Cir. 1987).

[39] *See* Brown, *supra* note 7 at 1197-1198.

[40] *See* EPSTEIN, *supra* note 8 at 671.

[41] *See* Brown, *supra* note 7 at 1244-1250.

[42] Brown, *supra* note 7 at 1257 (quoting United States v. Zolin, 491 U.S. 554, 572 (1989).

[43] *See* Gideon Mark and Thomas C. Pearson, *Corporate Cooperation During Investigations and Audits*, 13 Stan. J.L. Bus. & Fin. 1, 1 (2007).

[44] American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations*, 41 Duq. L. Rev. 307, 339-340 (2003).

[45] *See* In re Pub. Def. Serv., 831 A.2d 890, 902 (D.C. 2003).

[46] In re Grand Jury Subpoena, 662 F.3d 65, 70 (1st Cir. 2011).

[47] American College of Trial Lawyers, *supra* note 44 at 342 (quoting In re Grand Jury Subpoenas, 144 F.3d 653, 662 (10th Cir. 1998).

[48] United States v. Zolin, 491 U.S. 554, 574 n.12 (1989).

[49] Glen Austin Sproviero, *High Cost of a Low Threshold: The Policies and Practicalities Underlying the Crime-Fraud Exception to the Attorney-Client Privilege*, The Criminal Law Reporter, 89 CrL 262, 2 (May 25, 2011), available at http://www.coleschotz.com/2B7963/assets/files/News/352.pdf.

[50] Mark A. Thornhill et al., *Peering into Lawyers' Files – Prosecutors' Use of the Crime or Fraud Exception*, 2001 A.B.A SECTION ENV'T, ENERGY & RES. 4, available at http://apps.americanbar.org/environ/committees/environcrimes/thornhill.pdf.

[51] U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL 9-13.410 (2009), available at http://www.justice.gov.

[52] U.S. DEP'T OF JUSTICE, *supra* note 51 at 9-13,410 (B).

[53] American College of Trial Lawyers, *supra* note 44 at 343-344.

[54] Sproviero, *supra* note 49 at 3.

[55] *See* United States v. Under Seal (In re Grand Jury Proceedings), 33 F.3d 342, 344-345 (4th Cir. 1994).

[56] In re Grand Jury Subpoena, 884 F.2d 124, 126-127 (4th Cir. 1989).

[57] *See* United States v. Under Seal (In re Grand Jury Proceedings), 33 F.3d 342 at 353.

[58] *See generally* MODEL RULES OF PROF'L CONDUCT (2016), available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html.

[59] *See* Martin G. Weinberg & Kimberly Homan, *Challenging the Law Office Search*, 20 Champion 10, 10 (Aug. 1996), available at https://www.nacdl.org/CHAMPION/ARTICLES/96aug04.htm.

[60] United States v. Skeddle, 989 F. Supp. 890, 898 (N.D. Ohio 1997); *but see* United States v. Abbell, 914 F. Supp. 519 (S.D. Fla. 1995) (holding privilege issues were so extraordinary as to require an independent third party to search through the materials).

[61] *See* U.S. DEP'T OF JUSTICE, *supra* note 51 at 9-13.420 (D)-(E).

[62] Eric d. McArthur, *The Search and Seizure of Privileged Attorney-Client Communications*, 72 U.Chi.L. Rev. 729, 738-739 (Spring, 2005).

[63] *See* EPSTEIN, *supra* note 8 at 1339.

[64] *See* U.S. DEP'T OF JUSTICE, *supra* note 51 at 9-13.420(F).

[65] *See* Weinberg, *supra* note 59.

[66] Haines v. Liggett Grp., Inc., 975 F.2d 81, 90 (3d Cir. 1992) (citing Model Rules of Professional Conduct Rule 1.6 (1983)).

[67] *See id.*

[68] Vince Farhat & Calon Russell, *"Houston, We Have a Problem": Clients Who Engage in Unlawful Conduct During Your Representation*, American Bar Association Criminal Justice Section's White Collar Crime Committee Newsletter, 1, 1-3 (Winter/Spring 2015), available at http://www.americanbar.org/content/dam/aba/publications/criminaljustice/wcc_newsletter_unlawful_conduct.authcheckdam.pdf.

[69] *See generally* MODEL RULES, *supra* note 58 (The ABA website includes a comprehensive list of the differences between jurisdictions' adoption of the Model Rules).

[70] MODEL RULES, *supra* note 58 at R. 1.2 (d).

[71] *See* Farhat, *supra* note 68 at 2-3 (citing Rule 1.6 of ABA Model Rules of Professional conduct which lists a number of reasons in which an attorney may reveal a client's confidential information—including preventing death or substantial harm, preventing financial injury, court order, etc.).

[72] *See* Farhat, *supra* note 68 at 4 n.10.

[73] *See* United States v. Cavin, 39 F.3d 1299, 1308-1310 (5th Cir. 1994).

[74] *See id.* at 1308.

[75] *See* United States v. DeLucca, 630 F.2d 294, 301 (5th Cir. 1980).