No. 10-3770

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

RONALD R. PETERSON, not individually but as Chapter 7 Trustee
for the bankrupt estates of Lancelot Investors Fund L.P.,
Lancelot Investors Fund II L.P., Lancelot Investors Fund Ltd.,
Colossus Capital Fund L.P., and Colossus Capital Fund Ltd.,

Plaintiff-Appellant,

v.

MCGLADREY & PULLEN LLP, *et al.*,

Defendants-Appellees.

On Appeal From The United States District Court
For The Northern District Of Illinois, Eastern Division
In No. 10 C 274
Hon. Elaine E. Bucklo

BRIEF OF *AMICI CURIAE* THE CENTER FOR AUDIT QUALITY AND THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT OF APPELLEES MCGLADREY & PULLEN LLP AND MCGLADREY & PULLEN, CAYMAN AND AFFIRMANCE

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DISCLOSURE STATEMENT PURSUANT TO FEDERAL RULE OF APPELLATE PROCEDURE 26.1

1. The full name of all *amici curiae* represented by the undersigned attorneys in this case:

   The Center for Audit Quality; The American Institute of Certified Public Accountants.

2. The names of all law firms whose partners or associates have appeared for *amici curiae* in this case:

   Gibson, Dunn & Crutcher LLP.

3. If *amici curiae* are corporations:

   a. Identify *amici curiae*'s parent corporations:

      None.

   b. List any publicly held company that owns 10% or more of *amici curiae*'s stock:

      None.

Dated: May 17, 2011

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The Center for Audit Quality ("CAQ") and the American Institute of Certified Public Accountants ("AICPA") (collectively, "*amici*") respectfully submit this brief as *amici curiae*, pursuant to Federal Rule of Appellate Procedure 29, in support of McGladrey & Pullen LLP and McGladrey & Pullen, Cayman (collectively "McGladrey"). This brief is filed pursuant to the consent of all parties.

STATEMENT PURSUANT TO FEDERAL RULE OF APPELLATE PROCEDURE 29

Counsel for *amici* authored this brief in its entirety. No other party's counsel authored this brief in whole or in part. No party or party's counsel contributed money that was intended to fund preparing or submitting the brief. No person, other than the *amici*, their members, or their counsel, contributed money that was intended to fund preparing or submitting this brief.

INTEREST OF THE CENTER FOR AUDIT QUALITY AND THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICI CURIAE*

The CAQ is a public policy organization that seeks to aid investors and the capital markets by advancing constructive suggestions for change rooted in the audit and accounting profession's core values of integrity, objectivity, honesty, and trust. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") may join the CAQ. The CAQ is affiliated with the AICPA, and has approximately 750 U.S. public company accounting firms as members (including McGladrey & Pullen LLP), representing tens of thousands of professionals dedicated to audit quality.

The CAQ seeks to improve the reliability of public company audits and to enhance their relevance for investors, particularly in this time of growing financial complexity and globalization. The CAQ is dedicated to helping increase public confidence in the auditing process and to maintaining high standards in the accounting profession. To fulfill its mission, the CAQ offers recommendations to policymakers, issues technical support for public company auditing professionals, and participates in the public discussion about financial reporting. Among many other activities, the CAQ regularly submits *amicus* briefs in cases concerning auditors and the audit process.

The AICPA is the national organization of the certified public accounting profession with nearly 370,000 members involved in public accounting, business and industry, government, and academia. Members' firms audit the financial statements of virtually every public company in the United States, and thus they are often drawn into litigation involving issues such as those presented in this case.

Among the AICPA's purposes are the promotion and maintenance of high professional standards of practice. Because of its historical role in formulating standards relating to audits, reviews, compilations, and attest engagements, and the reports issued thereon, the AICPA maintains a strong interest in the scope and bases of civil liability sought to be imposed on accountants pursuant to those standards. The AICPA regularly submits *amicus* briefs in actions concerning these issues.

Accordingly, *amici* have a keen interest in this case, because it concerns legal rules that affect accountants and the audit process, and that have a broader impact on

investors and the capital markets. *Amici* believe the views expressed herein will be beneficial to the Court.[1]

BACKGROUND

This case arises out of the bankruptcy of five hedge funds (collectively, the "Funds"), founded and operated by Gregory Bell. The Funds invested primarily in Thousand Lakes LLC ("Thousand Lakes"), an entity that allegedly used the financing from the Funds to purchase goods from suppliers and resell them to major retailers. In reality, Thousand Lakes was merely a vehicle for a Ponzi scheme that, at some point, Bell joined and aided. While the fraudulent scheme was ongoing, McGladrey audited the 2006 and 2007 financial statements of the Funds.

After a federal investigation uncovered the Ponzi scheme in September 2008, the Funds filed for bankruptcy and Ronald R. Peterson was appointed the Chapter 7 Trustee for the Funds (the "Trustee"). The Trustee subsequently filed suit against Bell and the Funds' management companies in the United States Bankruptcy Court for the Northern District of Illinois, alleging negligence, gross negligence, breach of fiduciary duty, and unjust enrichment, among other things, for Bell's role in the fraudulent scheme. The Trustee also brought suit against McGladrey in the District Court for the Northern District of Illinois, claiming that McGladrey was negligent in its audits of the

[1] This brief also addresses arguments made in the *amicus* brief already filed by the National Association of Bankruptcy Trustees ("NABT"), supporting Appellant. *See* Brief of *Amicus Curiae* NABT, *Peterson v. McGladrey & Pullen LLP*, No. 10-3770, at 8-16 (Mar. 16, 2011) ("NABT Amicus Br.").

Funds. The district court granted McGladrey's motion to dismiss, holding that the Trustee's claims were barred under the doctrine of *in pari delicto*.

SUMMARY OF ARGUMENT

The Trustee's proposed limitation of the *in pari delicto* defense, which would render it inapplicable in the bankruptcy context, cannot be squared with the Bankruptcy Code. It also conflicts with the decisions of every Circuit Court to consider the issue, and with the important policy objectives of deterring misconduct and avoiding judicial intervention in disputes between alleged wrongdoers. Moreover, the Trustee's interpretation of the doctrine would expand auditor liability dramatically, remove important incentives for boards of directors to oversee management and for creditors to conduct due diligence, and threaten the sustainability of the auditing profession.

The *in pari delicto* defense bars a plaintiff from obtaining damages from a defendant when the plaintiff is equally at fault for the harms underlying the claims. The defense also applies to bar claims brought by or on behalf of a corporation when the corporation is at fault for the underlying conduct due to the actions of its employees. Under settled principles of agency law and imputation, the wrongdoing of a corporation's employees is attributed to the corporation when the employees act within the scope of their employment.

The *in pari delicto* defense applies to bankruptcy trustees because, under the express terms of Section 541 of the Bankruptcy Code, the trustee stands in the place of the debtor and is subject to all claims *and defenses* that may have been asserted against the debtor corporation. Federal law prohibits any state-law exception which purports to

allow a bankruptcy trustee to avoid the *in pari delicto* defense based on the interests of "innocent" creditors. Moreover, even if federal law did not bar such an exception, bankruptcy trustees bring claims on behalf of the malfeasant debtor estate—not innocent creditors.

Perhaps recognizing that the *in pari delicto* defense generally applies with full force in the bankruptcy context, the Trustee argues that it should not apply to the particular facts of *this* case, on the theory that the company in which the Funds primarily invested misled McGladrey and the Funds before the Funds themselves joined in the fraud. However, the underlying justifications of the *in pari delicto* defense—that courts should not resolve disputes between wrongdoers and that denying relief to an admitted wrongdoer will deter illegality—apply notwithstanding the characterization or timing of plaintiff's wrongdoing.

The *in pari delicto* defense is of exceptional importance to the accounting profession, which must rely on the integrity of the management of public companies as part of the audit process. Auditors are the targets of choice in lawsuits where company management has perpetrated a fraud on investors and creditors, despite the fact that the auditors are also a victim of their client's fraud. Stripping auditors of the *in pari delicto* defense, whether in the bankruptcy context or even more broadly, would dramatically increase auditor liability and would not serve the public interest for several reasons. First, depriving auditors of the *in pari delicto* defense would not improve deterrence of misconduct nor punish wrongdoers. Second, expanding auditor liability where the corporation is at fault would reduce the incentive of boards of directors to select honest

management, to delegate duties with care, and to engage in active oversight of management. Such a change also would reduce the incentive of third parties such as creditors and investors to conduct their own due diligence. Third, expanding auditor liability would exacerbate serious systemic risks that could impact the sustainability of the accounting profession and erode the competitiveness of the U.S. capital markets.

Accordingly, the Trustee's attempt to circumvent the Bankruptcy Code, strip auditors of the *in pari delicto* defense, and expand auditor liability should be rejected.

ARGUMENT

I. The *In Pari Delicto* Defense Applies With Full Force In The Bankruptcy Context

A. It Is Well-Established That The *In Pari Delicto* Defense Applies To Claims Brought By Bankruptcy Trustees

All seven Circuit Courts to analyze the question have concluded that the *in pari delicto* defense applies to bankruptcy trustees.[2] The plain text of the Bankruptcy Code permits no other conclusion. Section 541 of the Bankruptcy Code expressly limits the property of the bankruptcy estate to the "legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." 11 U.S.C. § 541(a)(1). The phrase "legal or equitable interests" has been construed broadly to include "any legally

[2] *See, e.g.*, *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006); *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 158-66 (2d Cir. 2003); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356-57 (3d Cir. 2001); *In re Dublin Sec., Inc.*, 133 F.3d 377, 380 (6th Cir. 1997); *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 836 (8th Cir. 2005); *Mosier v. Callister, Nebeker & McCullough*, 546 F.3d 1271, 1276 (10th Cir. 2008); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1150 (11th Cir. 2006).

enforceable right." *In re Carlson*, 263 F.3d 748, 750 (7th Cir. 2001). Thus, bankruptcy trustees stand in the place of the debtor and may bring any suit that the debtor could have brought outside of bankruptcy. *Edwards*, 437 F.3d at 1149. The trustee is subject, however, "to *all claims and defenses* which might have been asserted against the bankrupt but for the filing of the [bankruptcy] petition." *Bank of Marin v. England*, 385 U.S. 99, 101 (1966) (emphasis added).[3] The *in pari delicto* defense falls within this rule. *E.g.*, *Grassmueck*, 402 F.3d at 836; *R.F. Lafferty & Co.*, 267 F.3d at 355-56.

B. Any Attempt To Treat The Asserted "Innocence" Of Bankruptcy Creditors As A Bar To The *In Pari Delicto* Defense Conflicts With Governing Federal Bankruptcy Law

The Trustee asks this Court to depart from its sister Circuits by recognizing an exception to the *in pari delicto* defense in the bankruptcy context, because the beneficiaries of a judgment would be the "innocent" creditors of the debtor corporation. *See* Trustee Br. 21. This proposed exception violates the express language of Section 541, which limits the property of the estate—by whomever held, including the Trustee or debtor-in-possession—to the debtor's interest "as of the commencement of the [bankruptcy] case," thus placing "both *temporal* and *qualitative* limitations on the reach of the bankruptcy estate," *In re Hedged-Invs. Assocs.*, 84 F.3d 1281, 1285 (10th Cir. 1996) (emphases added). Temporally, the statute establishes a definite date after which

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3 *Bank of Marin* was decided under Section 70(a) of the Bankruptcy Act of 1898. Although the Bankruptcy Code was enacted in 1978, Section 70(a) was retained without substantive change and recodified at 11 U.S.C. § 541. *Compare* Bankruptcy Act of 1898, ch. 541, § 70, 30 Stat. 544, 565-66 (1898) (codified at 11 U.S.C. § 110 (1976)), *with* 11 U.S.C. § 541(a).

property acquired by the debtor will generally not become property of the estate. Qualitatively, it makes clear that the estate's rights are "no stronger than they were when actually held by the debtor." *Id.*; *see also R.F. Lafferty & Co.*, 267 F.3d at 357.

The estate "succeeds only to such rights as the *bankrupt* possessed" pre-bankruptcy, not more. *Bank of Marin*, 385 U.S. at 101 (emphasis added). Thus, under Section 541, a cause of action belonging to a debtor that was not viable *before* the commencement of bankruptcy, is also not viable when asserted by the trustee *after* bankruptcy. *See id.* The Trustee suggests nevertheless that state law provides an exception, whereby the *in pari delicto* defense does not apply to trustees bringing claims on behalf of "innocent" creditors. *See* Trustee Br. 21, 23-26. But even if that state-law exception did exist—it does not—it would be barred by Section 541. Thus, the Trustee's proposed rule would directly and impermissibly conflict with federal law. *See Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000); *Geier v. Am. Honda Motor Co.*, 529 U.S. 861, 873-74 (2000).

The legislative history of Section 541 confirms that the debtor's estate cannot be altered post-bankruptcy on account of creditors' purported "innocence." Both the Senate and House Reports emphatically state that Congress intended that the creditors can "take no greater rights than the debtor." S. Rep. No. 95-989, at 82 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5868 (explaining, by way of example, that when a debtor's claim is barred at the time of commencement of bankruptcy by the statute of limitations, the trustee would also be barred from pursuing the claim); *see also* H.R. Rep. No. 95-595, at 367-68 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6323 (same). The Trustee's

argument is therefore inconsistent with both the text and legislative history of Section 541.

This Court's decision in *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995), where the Court declined to apply the *in pari delicto* doctrine to a receiver bringing fraudulent conveyance actions, does not stand for a different rule. As several federal courts have held, the powers of the receiver in *Scholes* were derived from state law, and thus Section 541 did not apply. *See, e.g.*, *R.F. Lafferty & Co.*, 267 F.3d at 358 (distinguishing *Scholes* because "unlike bankruptcy trustees, receivers are not subject to the limits of section 541"); *Grede v. McGladrey & Pullen LLP*, 421 B.R. 879, 884 (N.D. Ill. 2009) (distinguishing *Scholes* and cases dealing with receivers because "[r]eceivers' powers are derived from state law [whereas] trustees garner their authority from federal law"); *Edwards*, 437 F.3d at 1151-52 (same); *In re Hedged-Invs. Assocs.*, 84 F.3d at 1284-85 (same). That is also true for the other receivership cases on which the Trustee and NABT rely. To the extent that there are a handful of bankruptcy cases supporting an "innocent" successor-in-interest rule, they contravene Section 541 and established Supreme Court precedent such as *Bank of Marin*. *See also Zartman v. First Nat'l Bank of Waterloo*, 216 U.S. 134, 138 (1910) (The bankruptcy trustee or creditor "takes the property of the bankrupt, not as an innocent purchaser, but as the debtor had it at the time of the petition, subject to all valid claims, liens and equities.").

Further, this Court subsequently explained that its equitable holding in *Scholes* was based on an exception to the *in pari delicto* defense for fraudulent conveyances. *Knauer v. Jonathon Roberts Fin. Grp., Inc.*, 348 F.3d 230, 236 (7th Cir. 2003) (applying Indiana law

and explicitly limiting the holding in *Scholes*). The Court noted that in such a case, the defendant is the *beneficiary* of the malfeasant corporation's fraud—something that is not present here. *Id.* Moreover, in fraudulent conveyance claims, such as *Scholes*, the receiver sues on behalf of creditors. By contrast, in this case and other actions under Section 541, the trustee brings an action belonging to the debtor at the time of the filing of the bankruptcy petition and stands in the corporation's shoes.

Even if one could make a policy argument for an exception to the *in pari delicto* defense on behalf of "innocent" creditors, "the issue is not whether such an exception would make good policy but whether the exception can be found in the Bankruptcy Code." *In re Hedged-Invs. Assocs.*, 84 F.3d at 1286; *see also Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (noting that "[t]he issue, however, is not whether imposing [liability] is good policy but whether [it] is covered by the statute"). The Trustee cannot cite a single provision in the Bankruptcy Code to support the exception he seeks.

C. The Interests Of "Innocent" Creditors Do Not Justify Denying Auditors The Protections Of The *In Pari Delicto* Defense

Bankruptcy trustees do not bring claims on behalf of the innocent—they bring claims on behalf of the debtor estate. As the First Circuit recognized, a debtor estate is not "an innocent target of the fraud but, rather, . . . a complicit party." *Nisselson*, 469 F.3d at 157. Accordingly, "bankruptcy trustees do not have access to an 'innocent

successor' exception as a way of shielding themselves from the operation of an in pari delicto defense." *Id.* at 156.[4]

Even if a bankruptcy trustee could be said to bring claims on behalf of innocent creditors or stakeholders of the malfeasant debtor corporation, there is no reason why those claims trump the claims of the innocent stakeholders and creditors of defendant outside professionals, to whom the costs of any judgment may be passed along. *See Kirschner v. KPMG LLP*, 938 N.E.2d 941, 958 (N.Y. 2010) (noting that the owners and creditors of defendant audit firms were at least as "innocent" as the unsecured creditors and stockholders of the fraudulent corporations); *see also Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982).

Moreover, to the extent there are innocent creditors of a debtor corporation, applying the *in pari delicto* defense to the bankruptcy trustee will not preclude them from seeking to recover through direct claims. *See, e.g.*, *Edwards*, 437 F.3d at 1151; *In re Dublin Sec., Inc.*, 133 F.3d at 380. The Bankruptcy Code, however, provides no basis to create a cause of action to benefit "innocent" creditors over outside professionals and other third parties who were also misled by the corporation's fraudulent activity. Thus, there is no compelling reason to expand auditor liability in the bankruptcy context by limiting the *in pari delicto* defense.

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[4] Even if the Trustee did represent the creditors, he is not entitled to a presumption that those creditors are innocent. If a creditor were bringing a direct action, it too might be subject to the *in pari delicto* defense.

II. There Is No Basis Here For This Court To Limit The *In Pari Delicto* Defense

Perhaps recognizing that the *in pari delicto* defense applies with full force in the bankruptcy context, the Trustee argues that it should not apply to the facts of this case because, he alleges, both parties were "merely negligent" and their wrongdoings were not concurrent. As explained below, the Trustee's attempt to dilute the *in pari delicto* doctrine is inconsistent with the purpose of the doctrine, which is firmly rooted in two public policy rationales: (1) that "courts should not lend their good offices to mediating disputes among wrongdoers," and (2) 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 (1985).

A. The *In Pari Delicto* Defense Is Not Limited By The Characterization Of Plaintiff's Wrongdoing

The Trustee erroneously asserts that the defense of *in pari delicto* "does not apply" because "the allegation is that both parties were merely negligent." Trustee Br. 20. First, the Trustee has alleged that Bell, a principal of the debtor corporation, engaged in wrongdoing other than negligence, including gross negligence, breach of fiduciary duty, and fraudulent conduct. *See* Bell Compl. ¶¶ 115-36. Thus, the Trustee's own allegations preclude his argument.

Moreover, the Supreme Court has explained that the "need to deter illegal conduct is not eliminated" by the fashion in which the plaintiff frames its allegations or by the degree of culpability alleged. *Pinter v. Dahl*, 486 U.S. 622, 634 (1988). The fundamental purpose of the *in pari delicto* defense persists, "[r]egardless of the degree of scienter." *Id.*

Federal courts have affirmed the notion that the *in pari delicto* "analysis ordinarily will be the same across a spectrum of different causes of action." *Nisselson*, 469 F.3d at 152. For example, this Court affirmed an application of the *in pari delicto* defense when plaintiffs were "recklessly indifferent" to the same conduct for which they then sought to sue. *Stuart Park Assocs. Ltd. P'ship v. Ameritech Pension Trust*, 51 F.3d 1319, 1322 (7th Cir. 1995). The doctrine of *in pari delicto* applies with equal force when plaintiff engages in gross negligence or breach of fiduciary duty. *See In re Scott Acquisition Corp.*, 364 B.R. 562, 566 (Bankr. D. Del. 2007); *see also Gray v. Evercore Restructuring, L.L.C.*, 544 F.3d 320, 325-26 (1st Cir. 2008) (dismissing claims of gross negligence and breach of fiduciary duty against outside professionals who prepared an unsuccessful restructuring plan because the corporation was at least equally negligent in developing the plan); *In re Mediators, Inc.*, 105 F.3d 822, 825-26 (2d Cir. 1997) (barring corporation's claim against auditors and counsel because the corporation participated in the alleged breach of fiduciary duty).[5]

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[5] Comparative negligence is not at issue because Bell admitted to fraud. *See, e.g.*, Bell Compl. ¶¶ 10, 95. Illinois' modified comparative fault regime should not displace the doctrine of *in pari delicto*. *See Kirschner*, 938 N.E.2d at 957; *see also In re Scott Acquisition Corp.*, 364 B.R. at 568 (collecting cases from various jurisdictions affirming the principle that the doctrine of *in pari delicto* may be applied without mention of a state's comparative fault statute). In any event, as discussed below in Section III.B, the Funds were *primarily* responsible for the accuracy of the financial statements and for policing corporate fraud, and thus bear greater fault. *See, e.g.*, *Cenco Inc.*, 686 F.2d at 456.

B. The *In Pari Delicto* Defense Is Not Restricted To Concurrent Wrongdoing

The Trustee also claims that the *in pari delicto* defense does not apply because Bell's fraud occurred after the date of the last financial statements of the Funds that McGladrey audited, even though Bell's wrongdoing (and therefore the Funds' wrongdoing via imputation) was the direct cause of the Funds' ultimate loss. Trustee Br. 17; *see also* Trustee Br. App. 3 (Bell's wrongdoing "directly caused the losses that in this case plaintiff claims McGladrey indirectly caused through its negligent failure to uncover the Ponzi scheme."). The *in pari delicto* doctrine, however, "prohibits a plaintiff from maintaining a claim if the plaintiff himself bears equal fault for the alleged *injury*." *Knauer*, 348 F.3d at 233 (emphasis added). The defense is therefore not restricted to the same or concurrent wrongdoing, but rather requires the plaintiff to bear equal responsibility for the alleged *harm*. In this case, the Trustee alleges harm of a "more than $1.5 billion" loss to the Funds against both Bell and McGladrey. Am. Compl. ¶¶ 60, 67; Bell Compl. ¶¶ 3, 119, 124, 131. Indeed, the Trustee does not allege that any injury occurred until the time at which the Funds' management began actively engaging in the fraud.

The rule proposed by the Trustee suggests that courts must inquire into the knowledge or intent of the malfeasant debtor at each point in time when someone else might have been negligent. This approach would not only be cumbersome, but would likely require discovery and encourage tactical pleading. Plaintiffs invariably could—and would—seek to evade the *in pari delicto* defense by alleging that the misconduct of

the debtor corporation did not coincide with the misconduct of the auditor or other potential defendants. Consequently, those defendants—however innocent and careful they had been, and however deceptive the management of the client had been—could be propelled into costly, distracting, and ultimately meritless litigation. Such a rule makes little sense. The correct application of the rule, on the other hand, simply evaluates whether the debtor corporation—when it comes to court—is partially responsible for the harm for which it alleges the defendant is responsible. That evaluation can be made based on the pleadings. While any rule based on timing is easily manipulated, a rule that focuses on the injury cannot be so easily circumvented.

Moreover, the two underlying policy reasons for the defense—that courts should not expend precious judicial resources to mediate disputes between wrongdoers, and that denying relief to an admitted wrongdoer will help deter illegality, *Bateman Eichler*, 472 U.S. at 306—apply with equal force regardless *when* the plaintiff (or in the case of a trustee, when the debtor corporation it represents) engaged in the wrongdoing for which the fraudulent corporation seeks recovery.

Restricting the *in pari delicto* defense based on the timing of any number of alleged wrongdoings—rather than focusing on the *harm* that the debtor corporation inflicted on itself—would allow the Trustee (standing in the place of the Funds) to reap the unusual benefit of recovering from the Funds' own fraud simply because its wrongdoing occurred late in the day. This is clearly inconsistent with the purpose of the doctrine. *See, e.g.*, *Cenco Inc.*, 686 F.3d at 456.

III. Eroding The *In Pari Delicto* Defense For Auditors Would Not Deter Misconduct Or Improve Management, And Would Threaten The Sustainability Of The Accounting Profession

The *amicus* NABT's attempts to deprive auditors of the *in pari delicto* defense in the bankruptcy context would greatly expand the scope of auditor liability. Specifically, the NABT urges this Court to refuse to permit auditors to assert the *in pari delicto* defense on the ground that doing so would aid deterrence by increasing costs to auditors for failing to detect management's fraud. *See* NABT Amicus Br. 8-17.[6]

The NABT is mistaken. As discussed below, depriving auditors of a long-standing equitable defense does nothing to improve deterrence of auditor misconduct, but rather would reduce the incentive of boards of directors to properly oversee management. The same is true for creditors, who will have a reduced incentive to perform their own due diligence. Moreover, denying auditors the *in pari delicto* defense—and thereby expanding auditor liability—would disserve investors and further threaten the sustainability of the accounting profession. Thus, it is plainly in the public interest that

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[6] The NABT's argument was not made before the district court below or even by the Trustee to this Court, and therefore is not properly before the Court. *Nat'l Comm'n on Egg Nutrition v. FTC*, 570 F.2d 157, 160 n.3 (7th Cir. 1977) (noting that arguments raised in an *amicus* brief but not made below nor by the petitioner on appeal were not properly before the court).

the defense remain available to auditors in all contexts, including bankruptcy proceedings.[7]

A. Depriving Auditors Of The *In Pari Delicto* Defense Would Not Improve Deterrence Or Punish Wrongdoers

Deterrence of misconduct by auditors is a particularly dubious justification for stripping auditors of the *in pari delicto* defense because substantial deterrents already exist against misconduct. *See Cenco Inc.*, 686 F.2d at 455 (rejecting the deterrence justification). Auditors belong to a profession that values and fosters high professional standards, has robust and well-funded systems in place to help ensure ethical behavior, and is subject to extensive, multi-tiered regulatory oversight. "An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work."

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[7] The NABT also invites this Court to adopt the Pennsylvania Supreme Court's novel rule that an agent's misconduct is not imputed to its principal when the third-party defendant knowingly participated or acquiesced in the corporation's fraud. *See Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, 989 A.2d 313, 336-38 (Pa. 2010) ("*AHERF*"). Once again, this argument was not made to the court below or by the Trustee to this Court. Further, the Trustee has not alleged that McGladrey materially failed to act in good faith or secretly colluded with the Funds or any of their agents.

In any event, such a rule is at odds with Seventh Circuit and Illinois law, which recognize that the *in pari delicto* defense applies even when a third party participated in the alleged wrongdoing so long as the plaintiff "bears equal fault for the alleged injury." *Knauer*, 348 F.3d at 233; *see also King v. First Capital Fin. Servs. Corp.*, 828 N.E.2d 1155, 1173 (Ill. 2005). Moreover, the *AHERF* decision—which affirms auditors' general ability to assert the *in pari delicto* defense against audit clients—misconstrues settled principles of agency law. Whether an agent's knowledge or conduct is imputed to its principal turns entirely on the relationship between the principal and agent; the conduct or intent of third parties is, and should be, irrelevant. *See Kirschner*, 938 N.E.2d at 958 (declining to adopt *AHERF*'s rule and questioning whether such rule is "in the interests of fairness").

DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990). Auditors have little to gain but much to lose by not exposing a client's fraud. "It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (internal quotation marks omitted).

Just last year, the NABT made the precise "deterrence" arguments that it makes here in an *amicus* brief before the New York Court of Appeals. *Compare* Brief for NABT as *Amicus Curiae*, *Kirschner v. KPMG LLP*, 938 N.E.2d 94 (No. 2010-0151), 2010 WL 4109431, at 9-14 (July 22, 2010), *with* NABT Amicus Br. 14-17. The New York Court of Appeals, however, rejected the argument that expanding auditor liability "would produce a meaningful additional deterrent to professional misconduct or malpractice." *Kirschner*, 938 N.E.2d at 958. Indeed, the court explained that "outside professionals—underwriters, law firms *and especially accounting firms*—already are at risk for large settlements and judgments in the litigation that inevitably follows" a large corporate scandal. *Id.* (emphasis added). Accordingly, the court rejected the notion that broadening the adverse interest exception or restricting the availability of the *in pari delicto* defense "would result in any greater disincentive for professional malfeasance or negligence than already exists." *Id.*

Auditor misconduct is amply deterred by existing regulatory and civil liability. Auditors face significant sanctions at the hands of regulators charged with protecting the public interest (including the SEC, the PCAOB, and state regulators—who license all Certified Public Accountants). For example, the PCAOB "initiates formal investigations

and disciplinary proceedings[, . . . and] [t]he willful violation of any Board rule is treated as a willful violation of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78a *et seq.* – a federal crime punishable by up to 20 years' imprisonment or $25 million in fines ($5 million for a natural person)." *Free Enter. Fund v. PCAOB*, 130 S. Ct. 3138, 3148 (2010) (citing 15 U.S.C. §§ 78ff(a), 7202(b)(1) (2006)). Moreover, the PCAOB "can issue severe sanctions in its disciplinary proceedings, up to and including the permanent revocation of a firm's registration, a permanent ban on a person's associating with any registered firm, and money penalties of $15 million ($750,000 for a natural person)." *Id.* (citing 15 U.S.C. § 7215(c)(4)). As explained above, auditors are also subject to civil liability in actions brought against them directly by creditors and investors. Auditors therefore face significant deterrence from misconduct, even absent the dramatic expansion of liability the Trustee seeks here, and have "a great deal of incentive to ensure accurate reporting." *Baena v. KPMG LLP*, 453 F.3d 1, 9 (1st Cir. 2006).

Moreover, expanding auditor liability as proposed would, in many cases, impose disproportionate liability on professional, careful auditors who were lied to by their clients. Such liability would not serve the policy purpose of punishing wrongdoers. To the contrary, it would enable wrongdoers to avoid some of the negative consequences of their wrongdoing by shifting those consequences to less culpable third parties.

B. Expanding Auditor Liability Where The Corporation Is At Fault Would Reduce The Incentive Of Boards Of Directors To Oversee Management And Of Creditors To Conduct Due Diligence

The Trustee seeks to limit the responsibility of debtor corporations for the actions of their employees by urging this Court to make the *in pari delicto* defense unavailable

where a trustee is seeking to recover on behalf of the corporation, or, in the alternative, to broaden the extremely narrow adverse interest exception to that defense. But limiting the responsibility of companies for the actions of their employees would have the undesirable effect of *reducing* the incentive of the board of directors—the duly selected representatives of shareholders, charged with the governance of the entity—to police and deter fraud. Such a rule also would reduce the incentive of creditors to conduct due diligence, by effectively allowing creditors to make the auditor the insurer of creditor losses.

As this Court has stated, "if the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced." *Cenco Inc.*, 686 F.2d at 455; *see also Defer LP v. Raymond James Fin., Inc.*, 654 F. Supp. 2d 204, 218 (S.D.N.Y. 2009) (Imputation of management's knowledge and conduct to the company "creates incentives for the entity to create and maintain effective internal communications . . . ."). The board, in its oversight role, appoints, supervises, and can replace management. Just as "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality," *Bateman Eichler*, 472 U.S. at 306, it is also an effective means of encouraging the responsible selection and oversight of management. *See* Restatement (Third) of Agency § 5.03 cmt. b (2006).

The company's management and board of directors are better equipped to prevent fraud than outside auditors and advisors because management and the board design and implement the company's system of internal controls, and have the ability to

incentivize its employees to avoid, detect, and report dishonest behavior. Management generates and prepares the financial statement information that is the starting point for any audit. Moreover, while outside auditors are engaged to opine on a company's financial statements, management is primarily responsible for the preparation of those financial statements, and is thus responsible for any misstatements in them as well. *See, e.g.*, Codification of Accounting Standards and Procedures, Statement on Auditing Standards Nos. 78 & 82, AU § 110.03 (Am. Institute of Certified Pub. Accountants 1972) ("The financial statements are management's responsibility.") (adopted as PCAOB Interim Auditing Standard).

Shifting primary responsibility for the honesty of a company's employees, and the accuracy of its financial statements, from the company itself to the auditor would be inconsistent with the auditing standards, which provide that "because of the characteristics of illegal acts [such as fraud], an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed." Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 54 ("SAS 54"), AU § 317.07 (Am. Inst. of Certified Pub. Accountants 1989) (adopted as PCAOB Interim Auditing Standard). These standards make clear that auditors cannot be expected to detect all of the errors that may arise when a company's management defies its obligation to work with its auditors honestly and lawfully.

Similarly, the Trustee's proposed rule would reduce the incentive for creditors to investigate and oversee the companies with which they interact. Instead, outside

professionals such as auditors would be put in the position of insuring careless creditors, which can abdicate their due diligence responsibilities. *Cf. Zedan v. Habash*, 529 F.3d 398, 406 (7th Cir. 2008) (describing as the "better course" that "creditors . . . have an incentive to actively investigate a debtor for potential fraud").

Accordingly, reducing the incentive for boards of directors to oversee management responsibly and for creditors to conduct thorough due diligence would be detrimental to audit quality and to the interests of investors more generally.

C. Expanding Auditor Liability Would Disserve Investors And Threaten The Sustainability Of The Accounting Profession

Stripping auditors of the *in pari delicto* defense and thereby expanding auditor liability could also give rise to serious systemic risks that could have a profound impact on the sustainability of the accounting profession, with serious consequences for investors and the capital markets. Indeed, the unique regulatory and litigation burdens on U.S. auditors have already been identified as a factor contributing to the decline in the competitiveness of U.S. capital markets in recent years. Interim Report of the Committee on Capital Markets Regulation ("Interim Report") 4-5, 88-89 (2006). Unnecessarily expanding auditor liability would only exacerbate this problem.

The accounting profession is significantly burdened by litigation arising from a broad scope of liability and aggressive plaintiffs seeking "deep pockets." *See, e.g.*, Final Report of the Advisory Committee on the Auditing Profession ("Final Report") VII:25 (2008). Further broadening liability for auditors would disserve the public interest because "increased civil exposure [for accountants] must ultimately raise the price of

accounting services," burdening companies listed on the U.S. markets—and, ultimately, their investors and customers. *Baena*, 453 F.3d at 9; *see also SEC v. Tambone*, 597 F.3d 436, 452-53 (1st Cir. 2010) (Boudin, J., concurring) ("No one sophisticated about markets believes that multiplying liability is free of cost. And the cost, initially borne by those who raise capital or provide audit or other services to companies, gets passed along to the public."). "If there is excessive . . . litigation, too many resources will be spent on litigation and on litigation avoidance. The cost of capital will then increase just as if a wasteful tax had been imposed on capital formation." Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 732 (1995) (emphasis omitted); *see also* Irwin J. Sugarman, *Lawyers & Accountants Liability After Central Bank*, 1998 A.B.A. Sec. Litig. & Arb. G-79, at *G-79 (observing that extending the reach of civil liability under the federal securities laws "might, in fact, *harm investors*") (emphasis added).

In addition, the accounting "profession faces catastrophic litigation risk different from that of other businesses." Final Report at VII:27. Among other reasons, the fees received from an audit are disproportionately small relative to the auditor's potential liability for that audit, which in some cases could be deemed to equate to the full decline in a public company's market value resulting from revelation of an undetected fraud—an amount which is more commonly now counted in the billions of dollars. When the liability exposure is compared to the combined partner capital retained by the firms, the threat that catastrophic litigation poses to the viability of accounting firms is simply undeniable. *See* Interim Report at 87 (the liability exposure of accounting firms "exceeds the combined partner capital" of the largest firms); Eric L. Talley, *Cataclysmic*

Liability Risk Among Big Four Auditors, 106 Colum. L. Rev. 1641, 1642 (2006) ("Auditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the very viability of the industry as we know it.").

These risks have rendered third-party insurance for large company audits generally unavailable, further compounding the profession's risks. Moreover, expanding liability could bankrupt a major firm "with disastrous consequences for corporate governance worldwide" and for the availability of audit services. Interim Report at 86; *see also* Final Report at VII:26 ("[T]he threat of the loss of a major auditing firm due to litigation is real.").

This combination of catastrophic litigation risk and difficulty obtaining third-party insurance further impacts the sustainability of the profession by increasing concentration in the profession; this is because smaller auditing firms are reluctant to pursue large clients whose massive market caps could spell enterprise-threatening liability in the event of a stock drop. Final Report at VII:28.

Significantly, the threat of disproportionate liability can further "harm audit quality by discouraging the best and brightest from entering and remaining" in the profession, "inhibiting the use of professional judgment, impeding the evolution of more useful audit reports, and causing overly cautious audits or 'defensive' auditing." *Id.* Decreased talent retention would also significantly reduce audit capacity for the thousands of companies requiring audit services.

For all these reasons, the Trustee's and the NABT's proposed elimination or narrowing of the *in pari delicto* defense would have a negative impact on investor protection and audit quality, and thus, should be rejected.

CONCLUSION

For the foregoing reasons, this Court should affirm the district court's decision.

Dated: May 17, 2011

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I hereby certify that on May 17, 2011, I caused the foregoing brief to be electronically filed with the Clerk of the Court for the United States Court of Appeals for the Seventh Circuit by using the CM/ECF system.

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