THE NAFER RECEIVER
OFFICIAL PUBLICATION OF THE NATIONAL ASSOCIATION OF FEDERAL EQUITY RECEIVERS

This article originally appeared in the July 2023 | Issue 16 publication. For more information about NAFER, visit www.NAFER.org

In Pari Delicto and Evil Zombies

By Daniel Seligman

The Practitioner's Corner is a regular feature where NAFER members can contribute their personal perspective on issues facing receivers.

For decades, federal receivers have relied on Judge Richard Posner's memorable opinion in the "evil zombie case" to recover money from fraudsters and their associates. But recent court decisions suggest that his widely-cited opinion from 1995 may have limited value. It may not help receivers who seek damages from third parties – such as accountants, lawyers, advisors, and bankers – for aiding and abetting or negligently acquiescing to the scheme that injured investors or consumers.

To understand the current situation, we need to go back in time to the case of Michael Douglas, who was in prison when Judge Posner and his colleagues on the U.S. Court of Appeals for the Seventh Circuit ruled that the companies that Douglas had created as part of a Ponzi scheme were no longer "under his spell."[1] The "evil zombies" of his fraud, "his robotic tools," had been cleansed.[2] A federal equity receiver in Illinois could therefore sue on behalf of Douglas's corporations to recover money for investors who were harmed by Douglas's elaborate fraud.[3] The defendants in the case, who included Douglas's ex-wife, had argued that the receiver could not pursue claims against them because the receiver represented the same companies that Douglas had created – companies that were tainted by Douglas's actions, as if the receiver had somehow inherited Douglas's sins. Not so, Judge Posner said in *Scholes v. Lehmann*.[4] The corporations were distinct from Douglas and had separate rights. The receiver was not suing on behalf of Douglas but on behalf of people who were swindled. As a result, the *in pari delicto* doctrine (in "equal fault"), which generally prohibits one wrongdoer from suing another, did not apply. "The important thing" is that the investors "were not complicit in Douglas's fraud; they were its

CONTINUED NEXT PAGE

About The Author

Daniel Seligman is a lawyer and Certified Fraud Examiner in Seattle, Washington. He provides fact-finding, due diligence and investigative services to lawyers, insolvency practitioners and other clients, and is the co-chair of NAFER's Publications Committee. He wishes to thank **Robin Weiss**, senior attorney at Clark Hill in Philadelphia, for her legal research and edits to this article. The author also wishes to recognize the work of NAFER's Amicus Committee. **Michael Napoli** of the Akerman law firm in Dallas, one of the authors of NAFER's amicus brief, provided helpful comments for this article.

The Practitioner's Corner...continued from page 1

victims," Judge Posner wrote 28 years ago in *Scholes*.[5]

The *Scholes* opinion – and similar decisions around the United States – give receivers the authority to stand in the shoes of a corporation that was involved in the fraudulent scheme. Typically, the defendants in these cases are the fraudsters themselves as well as their families, colleagues and others who have unfairly profited from the scheme. Although the initial complaints are filed in federal court by regulatory agencies, such as the U.S. Securities and Exchange Commission, the Federal Trade Commission and the Commodity Futures Trading Commission, the receivers' task of recovering money is mostly an exercise under state law. In the *Scholes* case, the statute was the Illinois law of fraudulent conveyances.[6] But receivers have also attempted to rely on common law tort actions against third-parties to recover additional funds for victims. And that effort now faces new hurdles.

In pari delicto

The *in pari delicto* doctrine dates back to 18th century England. It's a doctrine grounded in equity, the inherent authority of the courts to find fairness and justice, and to look beyond the rigid rules of statutes and code books.[7] In its simplest terms, *in pari delicto* prohibits a plaintiff who was part of an illegal activity from using the courts to get money from a fellow conspirator. *In pari delicto* is a shield, raised by defendants who basically argue, "what are you suing me for? This was your scheme and you designed and participated in the fraud yourself."[8]

If both plaintiff and defendant are indeed equally (or substantially equal) in fault, there are two good policy reasons why courts should invoke the *in pari delicto* doctrine and *not* let the suit for recovery go forward. As the U.S. Supreme Court has explained in two cases from the 1980s, the last time it has spoken on the subject, courts should not mediate or resolve business disputes among wrongdoers who concocted or participated in the illegal behavior. Furthermore, the denial of relief to an admitted wrongdoer (i.e., a fraudster) is an effective means of deterring illegality.[9] Put another way, the *in pari delicto* defense is available where the defense can show two things. First, that the plaintiff is substantially responsible for the violations he or she seeks to redress. Second that preclusion of the suit (e.g., dismissing the case) would not interfere with the effective enforcement of the securities laws and protection of the investing public.[10]

In *Scholes*, the defendants tried to make this argument but Judge Posner rejected it. The "defense of *in pari delicto* loses its sting when the person who is *in pari delicto* [Michael Douglas] is eliminated….Now that the corporations created and initially controlled by Douglas are controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver's bringing suit to recover corporate assets unlawfully dissipated by Douglas."[11]

Virtually every other federal circuit has embraced this analysis when it comes to statutory fraudulent transfer claims. "The leading case explaining the principles that govern a federally appointed receivers' action under state law….is *Scholes v. Lehmann*…," the Fifth Circuit said in 2013 in *Janvey v. Democratic Senatorial Campaign Comm., Inc.*[12] Applying the principles of *Scholes*, the court found that the receiver had standing to assert fraudulent transfer claims. Federal district courts around the country have taken a similar approach and declined to apply the *in pari delicto* defense to bar a receiver's claims. "The court begins its analysis by looking to *Scholes v. Lehmann*," a district court in South Carolina said in a 2017 decision that barred the defendants in a Ponzi scheme from raising *in pari delicto* to shield themselves against a receiver's fraudulent transfer claim to recover funds.[13]

The Tort Conundrum

But what about torts actions against third parties, such as bankers, lawyers, accountants, and financial advisors who allegedly aided and abetted the fraudulent scheme or who negligently acquiesced to the deceptive practices by not stopping the fraud when they knew or should have known about it?

And that is where things get complicated.

The Seventh Circuit, for example, considered those facts in

2003 in *Knauer v. Jonathon Roberts Fin. Grp., Inc.*[14] Although the court cited the *Scholes* opinion, it reached a different conclusion under Indiana law because the defendants (corporate broker dealers) had not benefitted directly from the diverted funds and had derived no benefit from the embezzlement, though they were allegedly to blame in part for its occurrence because of their supposed negligence. The case therefore represented a "different equitable alignment," the court said.[15] The doctrine of "*in pari delicto* thus applies to defeat the receiver's claims," the court concluded.[16]

The Eleventh Circuit has also confronted these issues in a series of opinions dating back to 2014. In two companion cases, *Wiand v. Lee* and *Wiand v. Dancing $, LLC*, the court held that the receiver, Burton Wiand, had standing to pursue certain defendants for transfers made by Arthur Nadel, mastermind of a million-dollar hedge fund Ponzi scheme.[17]

The issue in both cases was whether the Florida Uniform Fraudulent Transfer Act ("FUFTA") allowed Wiand to void distributions and claw back money for investors. The court looked to Judge Posner's decision in *Scholes*. A receiver has standing to sue on behalf of the corporations that were injured by the Ponzi scheme operator, the court said in *Lee*. "Although the corporations constitute the 'robotic tools' used by the Ponzi operator, they are 'nevertheless in the eyes of the law separate legal entities with rights and duties,'" the court said, quoting Judge Posner.[18] Once the "Ponzi schemer" is removed and the receiver appointed, the receivership entities are no longer the "evil zombies" but are freed from his spell and become entitled to the return of money that was diverted for unauthorized purposes.[19]

But then in 2020 the Eleventh Circuit handed down its decision in *Isaiah v. JPMorgan Chase Bank*, where it addressed the right of the receiver to seek damages against the defendant bank for several torts: aiding and abetting; breach of fiduciary duty; conversion and fraud.[20] The receiver claimed that the bank helped facilitate the Ponzi scheme. The district court had dismissed those claims, and the appeals court affirmed because it found that routine bank reposit and withdrawals, as well as intercompany transfers between JPMorgan Chase accounts, were not "transfers" within the meaning of FUFTA. Nor did the Eleventh Circuit buy Isaiah's argument that he could pursue common law torts against the bank. The receiver had not shown that the corporation in receivership had at least one honest member of the board of directors or innocent shareholder. Without that showing, the fraud and intentional torts of the corporation's insiders could not be separated from those of the corporation itself. Thus, the receiver standing in the shoes of the corporation could not bring the tort claims. The receiver's ability to pursue the claims was barred "by the fact that the Receivership Entities were controlled exclusively by persons engaging in and benefitting by the Ponzi scheme, and so the Receivership Entities were not injured by that scheme."[21]

Two years later, in *Perlman v. PNC Bank, N.A.*, a divided panel of the Eleventh Circuit held that the receiver, Jonathan Perlman, could not rely on the Florida Deceptive and Unfair Trade Practices Act ("FDUTPA"), to satisfy the *Isaiah* test.[22] The statute, the court said, did not rectify the standing issue in *Isaiah*. Perlman, in the majority's view, still had to allege the presence of at least one innocent director or stockholder to have standing to bring aiding and abetting claims against PNC. In other words, the statute still required Perlman to show that the wrongful conduct of insiders could be separated from the corporate entities in the receivership. If not, the entities could not argue that they suffered an injury. [See additional analysis of the case by Gavin Gaukroger and Hal Levenberg at page 7 of this issue.]

A Pending Case of Importance

A case now on appeal raises even more questions. In 2022, a federal district court in Tampa dismissed a complaint by a receiver, Burton Wiand, on grounds that the receiver did not have standing to pursue his claims against defendant ATC Brokers LTD because of the *in pari delicto* defense.[23] The court dismissed the receiver's tort *and* fraudulent transfer claims against ATC without conducting a separate analysis for the fraudulent transfer claims. Although the court had appointed Wiand as receiver in 2019 and given him broad authority to bring actions in law or equity, the court summarily dismissed the receiver's claims against ATC on standing grounds.[24] It cited the *Isaiah* decision and a prior state court ruling, *Freeman v. Dean Witter Reynolds, Inc.*,[25] and appeared to lump together the statutory fraudulent transfer issues with third-party tortfeasor issues, as if they were one and the same.

Wiand has now filed an appeal with the Eleventh Circuit. To support Wiand's arguments on his claim against ATC (one of several raised in Wiand's brief), NAFER filed an *amicus curiae* brief with the court on March 20, 2023. NAFER said the district court's dismissal of the fraudulent transfer counts against ATC was clearly inconsistent with the holdings of *Isaiah* and other Eleventh Circuit decisions. The brief, written by the Akerman law firm, argued that "without any briefing, argument, analysis, or discussion," the court had mistakenly concluded that Wiand lacked standing to pursue the fraudulent transfer claims.[26] "Put simply, the baby (Fraudulent Transfer Claims) was thrown out with the bath water (Tort Claims)," NAFER argued.[27] If the lower court decision is allowed to stand, "future fraudulent defendants in nationwide receivership cases will likely attempt to improperly argue lack of standing and cite to this decision. At a minimum, this additional wasteful motion practice will form a costly and time-consuming obstacle to a receiver's ability to use fraudulent transfer statutes to do their jobs."[28]

Even if the Eleventh Circuit reverses the lower court, the challenges for Wiand and other receivers in similar positions remain of concern. Going after third-party wrongdoers is difficult, and the *in pari delicto* doctrine remains a formidable hurdle.

ENDNOTES

1 *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028, 116 S.Ct. 673, 133 L.Ed.2d 522 (1995)("*Scholes*").

2 *Scholes* at 754.

3 Douglas's activities in the late 1980s had come to the attention of the U.S. Department of Justice, which indicted him on multiple counts of mail fraud and one count of providing false documents to the U.S. Securities and Exchange Commission. Meanwhile, the SEC had charged him in civil suits with multiple violations of federal securities law, and a federal district court had appointed Stephen Scholes as receiver.

CONTINUED ON NEXT PAGE

The Practitioner's Corner...continued from page 3

4 *Scholes* at 754.

5 *Scholes* at 754.

6 Ill.Rev. Stat ch. 59 (1987). The law was repealed in 1990 when Illinois adopted the Uniform Fraudulent Transfer Act, 740 ILC 160. See *Scholes* at 753.

7 *Holman v. Johnson*, 1 Cowp. 341 (K.B. 1775). The words "*in pari delicto*" are part of a longer Latin phrase, "*in pari delicto potior est conditio defendentis*," which means that where the wrong of both parties is equal, the position of the defendant is stronger.

8 For an overview of these issues, see Steven Rhodes and Kathy Bazoian Phelps, "Equity Receivers and the *In Pari Delicto* Defense," 69 Bus. Law 699 (2014). Bankruptcy courts, which are bound to interpret the Bankruptcy Code, often reach different results, particularly when the cases involve section 541(a)(1), which creates an estate comprised of (among other things) "all legal or equitable interests of the debtor in property as of the commencement of the case." Courts have held that the bankruptcy trustee therefore holds all claims and defenses of the underlying corporation when it filed its petition and do not distinguish, as Judge Posner did in *Scholes v. Lehmann*, that the fraudster is no longer in control of his company. As a result, it is often easier for defendants in a bankruptcy action to assert the *in pari delicto* defense. For a critique of the bankruptcy approach, see Michael Napoli, Eduardo Espinosa and Patrick Stanton, "Through the Looking Glass: The Mechanical Misapplication of *In Pari Delicto* in Bankruptcy," Pratt's Journal of Bankruptcy Law (January 2016).

9 *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

10 *Pinter v. Dahl,* 486 U.S. 622 (1988).

11 *Scholes* at 754-755.

12 *Janvey v. Democratic Senatorial Campaign Comm., Inc.* 712 F.3d 185 (5th Cir. 2013). *See also*, *Eberhard v. Marcu*, 530 F.3d 122 (2nd Cir. 2008), *Marion v. TDI Inc.*, 591 F.3d 137 (3d Cir. 2010), *F.D.I.C. v. O'Melveny & Meyers*, 61 F.3d 17 (9th Cir. 1995 (per curiam), *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008), and *Wing v. Dockstader*, 482 Fed. Appx. 361 (10th Cir. 2012).

13 *Ashmore for Wilson v. Dodds*, 262 F.Supp. 3d 341, 348, 350-351 (D.S.C. 2017).

14 *Knauer v. Jonathon Roberts Fin. Grp., Inc.*, 348 F.3d 230 (7th Cir. 2003)("Knauer").

15 *Knauer* at 236.

16 *Knauer* at 238.

17 *Wiand v. Lee*, 753 F.3d 1194 (11th Cir. 2014)("*Lee*") and *Wiand v. Dancing $, LLC*, 758 Fed. Appx. 938 (11th Cir. 2014).

18 *Lee* at 1202.

19 *Lee* at 1202.

20 *Isaiah v. JPMorgan Chase Bank*, 960 F.3d 1296 (11th Cir. 2020) ("*Isaiah*").

21 *Isaiah* at 1308, relying on *Freeman v. Dean Witter Reynolds, Inc.*, 865 So.2d 543 (Fla. Dist. Ct. App. 2003).

22 *Perlman v. PNC Bank, N.A.*, 38 F.4th 899 (11th Cir. 2022). Jonathan Perlman is a partner in Venable LLP in Miami. He is currently serving as NAFER's president.

23 *Burton W. Wiand v. ATC Brokers LTD., et al*, case no 8:21-cv-1317-MSS-AAS, Order, September 27, 2022 (Doc. 67) ("ATC Order").

24 Initial Brief of Appellant, *Burton W. Wiand v. ATC Brokers LTD*, U.S. Court of Appeals for the Eleventh Circuit, Case 22-13658, March 3, 2023 (Doc. 18), pages 1-2.

25 *Freeman v. Dean Witter Reynolds, Inc.*, 865 So.2d 543 (Fla. Dist. Ct. App. 2003).

26 NAFER suggested the district court's decision to dismiss the fraudulent transfer claim with no analysis was simple error, an inadvertent mistake. But there are some indications the court misunderstood the *in pari delicto* doctrine. "Plaintiff [Receiver Wiand]'s ability to pursue these claims is barred because the OASIS Entities [defendants in the underlying action] were controlled exclusively by persons engaging in and benefitting from the Ponzi scheme, so the doctrine of *in pari delicto* does not [sic] apply….Accordingly, the Plaintiff's Amended Complaint is due to be DISMISSED WITH PREJUDICE." ATC Order at 28-29. To dismiss the complaint, the judge needed to find that *in pari delicto* did indeed apply. Otherwise, the conclusion makes little sense.

27 Brief of the National Association of Federal Equity Receivers, as Amicus Curiae Supporting Appellant, *Burton W. Wiand v. ATC Brokers LTD*, U.S Court of Appeals for the Eleventh Circuit, Case 22-13658, March 20, 2023 (Doc. 28) at pages 5-6.

28 *Id*.